AN ASSESSMENT OF THE MINORITY ENTERPRISE SMALL BUSINESS INVESTMENT COMPANY AS AN EFFECTIVE VEHICLE FOR PROVIDING VENTURE CAPITAL TO BLACK BUSINESS

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by

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CHAPTER I

INTRODUCTION

During the last decade, our minority population has been able to make dramatic strides toward achieving a greater degree of freedom and equality in most aspects of the American way of life. For the black segment of this minority population, to whom this study is directed primarily, this freedom has been over 100 years in coming.

Although total equality in the areas of employment, education, housing and the political process still has not been fully realized in the years since the issue of school desegregation was raised nationally in the 1950's, enough progress has been made to allow the focus of emphasis to shift somewhat from more individual freedoms to more collective ones. Some have termed this a desire for a more significant "piece of the action"--a greater collective involvement in the American economic mainstream that has always been beyond their grasp.

The concept of "Black Capitalism" made its first public appearance, in terms of true awareness by the majority population, at a meeting of the Urban Coalition in Washington, D.C. in the summer of 1968. It was during this time that the violence and destruction by the militant arm of the Black Power Movement had reached epidemic proportions. From the Birmingham riots in 1963 through the destruction of the Shaw District in

our nation's capital in 1968, deaths were totaling in the hundreds and property damage in the hundreds of millions of dollars. In a span of but a few days, 34 deaths and over $35 million in property damage occurred in the Watts area of Los Angeles alone.[1] Black and white leaders alike sought an end to this violence which was further widening the chasm of understanding between the races and also leaving the ghetto dwellers in a worse economic, social and political condition.

The Urban Coalition meetings became one of the key means by which the civil rights movement was shifted from destruction to construction. The black leaders replaced the need for more employment with the need to create opportunities for blacks to own, develop and manage their own businesses as the number one priority of the civil rights movement. When Roy Innes, a leader of the Congress on Racial Equality (CORE) and also a recognized spokesman of the wave of militancy prominent at the time, publically endorsed the concept of Black Capitalism in that same year, the full impact of this shift in emphasis by the great majority of black leaders was fully recognized as a possible solution to the problems that beset both the majority and the minority populations.[2] To the white community, capitalism was a concept well-understood and

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[1]"Financing Minority Businesses," The RMA Occasional Paper Series (Philadelphia: Robert Morris Associates, undated), p. 7.

[2]George T. Burtt, "Reading for Proof," review of Black Capitalism: Strategy for Business in the Ghetto, by Theodore L. Cross, in the Financial Executive, XXXVIII (September, 1970), 8.

and presented an approach by which both the public and private sectors might finally be able to truly assist the minorities. To the blacks, capitalism might be the means by which they could achieve the autonomy, independence, wealth, self-determination and self-esteem they had desparately sought through the Black Power Movement, but with disastrous results. It might also be the means to break the shackles of economic dependency which had kept them on the verge of a permanent welfare state, in spite of their other newly won freedoms.

Yet to get from the theoretical drawing boards to tangible visible results in the streets of the ghetto is another matter. One of the difficult problems to be resolved, and one that is still being hotly debated, is to overcome the inherent distrust many blacks have of the capitalistic system itself. After all, it was white capitalism that had brought them to this country in bondage in the first place and now it was supposed to help free them. Some young and highly educated black leaders feel even today that inherent in any capitalistic system is a class dichotomy that requires one small and dominant entrepreneurial group to control and exploit the masses. To pursue Black Capitalism, a term which has since been changed to black business development to play down the emphasis on the word capitalism, will be to just replace a white oppressor by a black oppressor. In either case the black masses will still be the exploited. Still, the overwhelming majority of black leaders highly endorse the concept. Their skepticism, however,

is focused on the sincerity and commitment of the white man, and especially any program that has Federal sponsorship.

Since the late 1960's, the Federal government has created a plethora of programs to assist minority businesses. As of the summer of 1971, there were 19 major Federal agencies sponsoring nearly 160 different programs that touch the area of minority enterprise in some way. Some, like the grazing association loans offered by the Department of Agriculture, can hardly be of significance to most minority entrepreneurs. Others, however, like the Minority Enterprise Small Business Investment Company (MESBIC) Program, are aimed directly at the minority businessmen located in the heart of the inner city areas.[1]

The MESBIC Program was launched with much fanfare, optimism and predictions by Secretary of Commerce Maurice Stans in 1969. It is based on the premise that there is a serious capital gap in the minority communities which prohibits black business development and that can only be overcome by Federal assistance. It is further based on the recognition that minorities, which comprise 16 percent of our population, own or control only 3 percent of our nation's business enterprises. Its purpose is to encourage the majority and minority private sectors to provide more venture capital to minority businessmen.[2]

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[1]U.S. Department of Commerce, Federal Programs Assisting Minority Enterprise (Washington, D.C.: Government Printing Office, 1971), p. v.

[2]U.S. Department of Commerce, MESBICs and Minority Enterprise (Washington, D.C.: Government Printing Office, 1971), p. 3.

It is believed that by assisting our minorities to participate more fully in the American economic mainstream, the private sector can "demonstrate (its) commitment to help resolve one of this nation's most pressing social problems."[1]

Statement of Research Question

The primary question this study seeks to answer, then, is whether the MESBIC Program can become a viable mechanism by which the Federal government can encourage and stimulate the growth of the black business community by joining with the private sector to increase the supply of venture capital to minority enterprises.

Before this primary question can be answered properly, it will be necessary to understand the problems with which the MESBIC Program is trying to cope. The first of these deals with the current status of minority enterprises, both qualitatively and quantitatively, and the extent of the capital gap existing in the minority communities. The second area of concern is the degree of responsiveness given to the needs of minority businessmen by both the majority and minority banking industries. Third, a brief analysis of the most important Federal programs dealing with the financial aspects of minority enterprises must be made in order to show where the MESBIC program does, or does not, fit into the total assistance package.

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[1] Ibid., p. 1.

With these questions properly dealt with, the mechanics of the MESBIC program itself can be described and an analysis can be made of its performance to date and prospects for the future.

Scope of the Study

The MESBIC program is but one of 160 Federal programs to assist minority enterprises and it works on but one of the four ingredients necessary for any business venture to achieve viability, that of venture and debt capital. The other three ingredients consist of the right man, the proper profit opportunity and the required degree of managerial and technical expertise. Although a successful business requires all four ingredients, studies have shown that new businesses fail due to a lack of a healthy financial structure, the lack of proper managerial expertise or a combination of both. This study will deal only with the financial aspects of minority business development, but some discussion will be directed toward the managerial assistance functions a MESBIC is supposed to provide.

Another restriction on the scope of this study is that although it deals with programs to assist all minority enterprises, total emphasis will be placed on the black business community. This is not meant to imply that other elements of the total minority population are not as important as the black segment, it is just that at this time the issue of black civil rights has been much more violent and visible. Also the black community is the largest single minority group accounting for

65 percent of the total minority population and over 50 percent of all minority enterprises.[1]

Purpose and Utility of the Study

The MESBIC program was launched as the first new direct assistance effort made by the Nixon Administration. Although under the operational control of the Small Business Administration, its chief advocate is the Office of Minority Business Enterprise (OMBE) in the Department of Commerce. OMBE's key function is to coordinate all Federal agency activity with respect to programs designed to assist in the development of minority businesses.

One purpose of this study, then, is to see if this broader coordination effort, under which MESBIC was created, has given it a better sense of direction and effectiveness than frequently has occurred with other Federal programs that have been fragmented in central direction by the autonomy of the agencies administering them.

Another purpose of this study is to see if the MESBIC program, which is a spin-off of the Small Business Investment Company (SBIC) program created by the Small Business Investment Act of 1958, has been properly modified and structured in order to avoid the pitfalls encountered in the early period of the latter's tempestuous history. In other words, is the MESBIC program just a warmed-over version of the SBIC program relabeled only for political purposes?

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[1] "Nixon Administration Responds to its Black Critics," Black Business Digest, II (December, 1971), 15.

A final purpose is to try to determine whether the Federal government has properly defined the objectives of its minority economic development programs. If it has, is the MESBIC program a proper delivery vehicle; and if not, can it survive in spite of its ill-conceived objectives?

The broader utility of this study, then, is to try to provide insight and, hopefully, a better understanding of whether we really know what it is we are trying to do for the minority segment of our population in terms of providing them greater economic freedom. Pouring good money after bad into programs that may be doomed to begin with is not only wasteful in an economic sense, it may also be financing a psychological condition that can further polarize the races.

Research Methods Utilized

Secondary data has been the major source of information for this study and an attempt has been made to utilize a wide range of sources to bring as broad a spectrum of opinions to bear on the subject as time allowed. Further, more emphasis has been placed on periodical references since the minority business enterprise area is so new and rapidly changing that data only three years old can be quite dated with respect to the current situation.

Primary data, in the form of private interviews with representatives of Federal agencies, and local quasi-public and private organizations assisting minority enterprises in the Washington Metropolitan area, has been used to supplement secondary data wherever possible.

Organization of the Study

In Chapter II, the minority business community itself is examined in both quantitative and qualitative terms. A case is presented for black business development and a determination of the reasons causing the wealth gap in the ghetto communities is attempted.

In Chapter III, the traditional commercial financial institutions, both minority-controlled as well as majority-controlled, is analyzed to determine to what extent they have been responsive to the needs of minority businessmen. Current trends in these industries with respect to this subject are also presented.

In Chapter IV an examination is made of the Federal financial assistance programs, exclusively those of the Small Business Administration, to assist minority businesses. The growth and development of SBAs major lending programs is presented.

In Chapter V is an analysis of the history, growth and performance of the SBIC industry. The importance of this analysis is that this industry represents the basic legislative and operational structure on which the MESBIC program is founded.

Chapter VI deals solely with the MESBIC program itself to see how it differs from that of the SBIC program and to look at its development and performance to date. An analysis of the MESBIC program's current and potential effectiveness is given both by those who advocate its potential effectiveness and those who challenge it as to concept and operation.

CHAPTER II

STATUS AND NEEDS OF BLACK BUSINESS

Introduction

Before any Federal assistance program is undertaken which commits public resources and funds to solve what has been determined to be a national problem, it is first necessary to define this problem, both quantitatively and qualitatively. Only when the problem is so defined can it be determined whether the programs selected to commit these resources are in fact the best solutions possible. The purpose of this chapter, then, is to try to better define the problem the MESBIC program hopes to solve.

To do this we will first describe the current status and profile of the black business community. Next we will examine the arguments concerning the merits of black business development itself. Finally an analysis will be made of the wealth gap that is said to exist in the black community which severely restricts the self-development of more viable businesses.

Current Status and Profile of the Black Business Community

In August of 1971, the Department of Commerce published the first comprehensive statistical data ever known to be compiled on the status of minority-owned businesses in our

country. The study, based on 1969 information accumulated by the Census Bureau and the Internal Revenue Service, leaves little doubt that our minorities have a rather miniscule "piece of the action" with respect to sharing in the economic wealth of our free enterprise system. For example, in 1969 there were approximately 322,000 minority business enterprises in our country, and 163,000 of those were black owned.[1] Based on an estimation that there were over seven million total businesses in our country in 1969, this means that all minorities owned or controlled 4 percent of our country's businesses and blacks only 2 percent.

In terms of total sales, the disparity is even greater. Based on 1967 data, the total receipts of all firms was $1,498 billion. Of that amount, all minorities contributed a total of $10.6 billion and blacks $4.5 billion. This means that black firms accounted for only 0.3 percent of all sales made.[2]

A comparison made with data on the billion dollar club in the May 1971 issue of Fortune makes an even more graphic contrast. It was shown that there were 120 companies each reporting sales in 1970 of over $1 billion. The bottom eleven firms alone grossed more than all minority businesses combined. Furthermore, General Motors, the nation's largest private business, reported sales of $18.8 billion in 1970, or nearly twice as much as the total sales of all 322,000 minority businesses combined. When the dimension of population is added,

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[1]U.S., Bureau of the Census, Minority-Owned Businesses: 1969, MB-1 (Washington, D.C.: Government Printing Office, 1971), pp. 1-2.

[2]Ibid., p. 1.

with blacks representing 11.3 percent of the population, the white-to-black ratios are 8.8 to 1 in population, 46 to 1 in business ownership and 333 to 1 in sales volume.[1]

Although the above figures are quite dramatic, they do little to provide a comparative profile of black-owned businesses with those of all businesses. Table 1 shows a comparison of black owned firms to all firms, by type of industry, with respect to number of firms and total receipts. As can be seen, black businesses are concentrated in the retail and service trades, with a total of 58 percent of all business receipts in these categories. They are least prevalent in the fields of finance, manufacturing, wholesale trade, and transportation and other public utilities. Yet their percentage of total receipts to the total business community even in the retail and service trades is still only 1.7 percent.

On an individual city basis, a recent survey of the Washington, D.C. area has provided the following profile of black businesses as of late 1968:[2]

1. The population of Washington is 70 percent black yet blacks own only 12 percent of all businesses.

2. Most of the black-owned businesses are in the service and retail areas.

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[1]"The Black-White Dollar Gap," Black Business Digest, II (December, 1971), 21.

[2]Maury Seldin and Michael Sumichrast, "Negro Entrepreneurship in the District of Columbia," (from an unpublished study Survey of Business Ownership in Washington, D.C., prepared for the Small Business Administration by the Homer Hoyt Institute of American University, Washington, D.C., March, 1969), pp. 9-10.

TABLE 1

RELATIONSHIP OF BLACK-OWNED FIRMS TO TOTAL FIRMS BY NUMBER, RECEIPTS AND INDUSTRY DISTRIBUTION AS OF 1969

Industry Classification	Total Number of Firms (000)			Total Business Receipts ($mil)			Distribution of Receipts (percent)	
	All	Black		All	Black			
	No.	No.	%	Amt.	Amt.	%	All	Black
Contract construction	856	16	1.9	$ 92,291	$ 464	0.5	6.1	10.4
Manufactures	401	3	0.8	588,682	303	0.1	39.3	6.8
Transportation and other public utilities	359	17	4.7	106,040	211	0.2	7.1	4.7
Wholesale trade	434	1	0.2	213,196	385	0.2	14.2	8.6
Retail trade	2,046	45	2.2	320,751	1,932	0.6	21.4	43.2
Finance, insurance and real estate	1,223	8	0.6	86,670	288	0.3	5.8	6.4
Selective services	1,803	56	3.1	61,858	663	1.1	4.1	14.8
Others (miscellaneous)	367	17	4.5	28,481	228	0.8	2.0	5.1
Totals	7,489	163	2.2	$1,497,969	$4,474	0.3	100.0	100.0

Source: U.S. Department of Commerce, Minority-Owned Business: 1969, pp. 2-3.

3. Most black-owned businesses are one-to-two man operations while white businesses employ an average of 6.6 persons. One-quarter of all black businesses have no paid employees, whereas one-quarter of all white businesses employ 20 or more people.

4. The median sales volume of all black businesses was less than $25,000 per year, in contrast to a white business sales median of $185,000 per year.

5. Most blacks acquired their business over ten years ago and during the last ten years there was nearly an equal trade-off between blacks acquiring white businesses and vice versa. In summary, then, we can picture the typical black business as a one man, retail- or service-oriented, ghetto-located operation that is barely able to support the proprietor and his family let alone contribute to the economic development of the black community.

The Case for Black Business Development

With a profile as bleak as that presented in the preceding section, it is easy to conclude that the black business community is not now even close to becoming a viable means of improving the economic status of our black citizens. But the issue of what should be done about stimulating a more viable black business community is far from being clearly defined, especially among the black citizens themselves. The debate varies from one extreme of those who contend that any attempt to further the achievements of black capitalism will only result in a deeper economic enslavement of the black masses. At the other

end of the continuum are those who believe that increased black business development can provide the only means of giving the black population the benefits of the full and equal citizenship it seeks.

Black sociologist E. Franklin Frazer has been one of the renowned contemporary critics of the black capitalists movement. As he wrote in Black Bourgeoisie, "The myth of Negro business is tied up with the belief in the possibility of a separate Negro economy . . . of course, behind the idea . . . is the hope of the black bourgeoisie that they will have the monopoly of the Negro market."[1] This implies that capitalism in any form will always tend to exploit the masses and that in fostering the growth of black capitalism, the white master will merely be replaced by a black master representing the black business elite.[2]

Followers of this line of thinking cite the fact that there have been many attempts made to stimulate black business development throughout our nation's history. Philadelphia's Free African Society was founded in 1787 by leaders of the black community to give it a more unified voice in the city's economic affairs. In 1865, the Freedman's Bank was established by Congress to help the country's new black citizens learn the white man's disciplines of thrift and saving. Booker T. Washington, in 1900, organized the National Negro Business League to stimulate the interest in and creation of more black businesses.

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[1]E. Franklin Frazer, Black Bourgeoisie (New York: Collier Books, 1957), p. 139.

[2]Earl Ofari, The Myth of Black Capitalism (New York: Monthly Review Press, 1970), p. 10.

All of these attempts to develop a viable black business community either ended in total failure or further exploitation of the black masses.[1] The only real solution to the plight of the black masses, according to the extreme anti-black capitalism followers, is to do away with our imperialistic economic system and replace it with a communization of all available resources in the black community. This will require a total class outlook toward the black liberation movement.[2]

The foregoing denouncement of black business development is still held by a relatively few number of individuals; but this type of thinking does have some influence on the problem. Moving up from this end of the continuum is a more prevalent viewpoint which does not question the necessity or merits of a more viable black business community. Rather it challenges the belief that business development is the black peoples' most urgent priority. Andrew F. Brimmer, who became the first black governor of the Federal Reserve Board when so appointed by President Lyndon Johnson in 1966, believes that the number one issue facing the black community is increasing the employment opportunities in the area of more meaningful and intellectually challenging work.

Brimmer believes that the decade of the 1970s will offer greatly expanding economic opportunities for which the black people must be prepared. A higher level of education and a

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[1] Ibid., pp. 13-47.

[2] Ibid., pp. 121-124.

wider range of new job skills are, to him, the only real elements that will help ensure that the black population is to achieve full participation in the open society. He further stresses that although there should be some striving for increased black business development, the events of history have not given the black community enough economic intelligence and business acumen to cope successfully with the complexities of modern business. He warns his people not to be led astray by what appear to be exciting and dynamic schemes to enhance economic development, and that once the ". . . fallacy of 'black capitalism' withers away, the emerging opportunities for genuine participation in business can be seen more clearly."[1]

In essence, then, Brimmer's position is that blacks should not be led into the trap of creating more "Mom and Pop" type enterprises, which typifies the current black business, since these businesses will not make black capitalists out of anyone, nor will they aid the black communities. Rather the black people should concentrate on strengthening their existing businesses and increasing their employment levels, job skills and economic intelligence, which in turn will set the stage for the eventual development of larger, more profitable black businesses.[2]

At the other end of the spectrum there are those like Dunbar S. McLaurin, a former professor of economics at several

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[1]Andrew F. Brimmer, "Economic Agenda for Black Americans," Black Business Digest, I (March, 1971), 36.

[2]Ibid., pp. 35-39.

colleges and now president of GHETTONOMICS, INC., a Harlem-based firm of ghetto economic consultants, who contends that "Brimmerism . . . is a desparate game of economic genocide for blacks . . . (which) advocates bringing Black Americans to the verge of full economic equality, but stopping just short of it." McLaurin sees that this line of reasoning will never give blacks the opportunity to actually own any part of the economic system in which they will only be allowed to work, regardless of whether this level of employment is more enlightening than it is now. The net result of Brimmer's approach will be to permanently relegate the black people to the role of "Marginal Americans."[1]

Samuel C. Thompson, a 27 year old MBA graduate of Wharton School of the University of Pennsylvania and also a graduate of Pennsylvania's law school, while also critical of Brimmer's total denouncement of the concept of black capitalism, believes that these thoughts should be put into proper perspective. To him Brimmer is correct to the extent that he believes the current thrust toward increased black ownership will only lead to the emergence of more "Mom and Pop" stores located solely in the ghetto areas, since the marginal business enterprise has little chance of success regardless of the color of the proprietor. But as Thompson sees it, like it or not, the "ownership bug is biting and aspirations are growing." He feels that the real meaning in Brimmer's message is not that blacks should avoid developing businesses, but that they should

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[1]Dunbar S. McLaurin, "White Brimmerism or Black Capitalism," Black Business Digest, I (March, 1971), 43.

place more emphasis on developing larger and more productive enterprises that will be viable to markets that extend beyond the boundaries of the ghetto.[1]

Abraham S. Venable, former Director of the Commerce Department's Office of Minority Business Enterprise and currently Director of Urban Affairs at General Motors, probably puts the whole issue in the best perspective in his contention that the debate over the merits of black business development has been going on since at least 1900, when Booker T. Washington formed the National Negro Business League to develop a plan to assist blacks to participate more fully in the country's business life. As Venable has stated it:

> The similarities in the conditions facing blacks then and now are striking and pitiful. Blacks in 1900 were debating the same issues we are debating today. Do we amass political power or economic power? Do we work toward a fully integrated society or for a parallel, black-owned and managed society? Do we keep on trying or do we give up and revolt? The pitiful part is that black ownership, still the victim of endless talk and discussion, has not advanced significantly.[2]

He believes that the time for philosophical debate is over and that employment programs alone, without ownership of some kind, are not enough since "Negroes had full employment on the plantation where our problems were the greatest."[3]

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[1]Samuel C. Thompson, Jr., "Black Ownership An Analysis and a Proposal - Part I," Black Business Digest, II (November, 1971), 46.

[2]Abraham S. Venable, "Black Business Development: Chaos in Transition?", Black Enterprise, II (September, 1971), 20.

[3]Ibid., p. 22.

The Capital Gap in the Black Community

It would appear that the debate over the merits of black business development may never be fully resolved to the satisfaction of all concerned since the business versus employment issue is somewhat analogous to the age old question concerning the chicken and the egg. In more pragmatic terms, there is a black business community that is functioning although somewhat marginally and precariously, and many blacks are firmly committed to the belief that total equality is directly linked to the future success of black business development.

If this commitment is so earnest, the question must be raised next as to why the black community cannot lift itself up by its own bootstraps as have other one-time American minority groups such as the Irish, the Italians and the Jews. The reasons are many and include among others the obvious issue of discrimination, the lack of a business heritage brought over from the "old country," the barriers toward developing a political power base and the inability to accumulate wealth. Although all of these reasons are interrelated and of equal importance, for the purposes of this chapter only the issue of accumulated wealth, or a community capital base, will be analyzed.

There appear to be two primary reasons why black communities cannot accumulate sufficient capital to build more viable businesses on their own. First is the wealth gap associated with the income patterns of black workers. Second is the makeup of the ghetto business community itself. With

respect to the income patterns, Venable put it well when he said:

> It is one of the more cruel ironies of the black experience in the United States that in 1789 when the Constitution was ratified the Negro was counted as three-fifths of a man for the purposes of representation and taxation. But today, 180 years later, the Negro is now counted as a whole man for the purposes of representation and taxation, but he earns only three-fifths as much as his white counterpart.[1]

This means simply that for every $100 a white man earns a black earns only about $60 for equivalent work. Add to this the estimation that in some ghetto areas black unemployment runs as high as 25 to 30 percent and the lack of an equitable accumulated gross income flowing into black communities would lead to the obvious conclusion that an income deficit does exist.[2]

More definitive than this, though, were the results of a 1967 study done by the Office of Economic Opportunity, which studied the size, composition and concentration of net wealth accumulated by black families as compared to white families. This study revealed that the disparity in net wealth, in holdings of land, property, securities and other such investments, is far greater than the current 40 percent net income spread, due to the legacy of past economic inequities in income distribution. It was further observed that current consumption studies show that blacks tend to save more than whites at any given income

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[1]Ibid., p. 22.

[2]Thompson, "Black Ownership An Analysis and a Proposal - Part I," 30.

level.[1] In conclusion, it was felt that even with the current trend toward a lesser income imbalance between races and the higher propensity to save, the black community can never hope to overcome this inherited wealth gap.[2]

Although the wealth gap itself might never be overcome, the fact that the income gap is closing should present some degree of optimism. Yet this optimism is soon shattered when one examines the flow of income within the black ghettos themselves. In 1967, the District of Columbia had a black population of nearly 70 percent, but a black business population of only about 7 percent. Estimates of gross sales of these businesses were between \$20 - \$40 million. Estimates of the sales of all commercial establishments were about \$4.8 billion. Thus the 7 percent black businesses accounted for at most only 1 percent of all sales.[3] The conclusion is that the black community acts merely as a conduit through which money flows in from the white community in the form of wages to the black workers and back out to the white community in the form of payment for goods and services purchased in the ghetto from white merchants.[4] As Ali Fatemi has stated, "It is obvious that such a short income

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[1]Henry S. Terrell, "Wealth Accumulation of Black and White Families: The Empirical Evidence," Journal of Finance, XXVI (May, 1971), 363.

[2]Ibid., 373.

[3]Mayor's Economic Development Committee, Report of the Committee, Overall Economic Development Program for Washington, D.C. (unpublished study, Washington, D.C., December, 1970), p. VII - 1.

[4]Thompson, "Black Ownership An Analysis and a Proposal - Part I," 31.

cycle prevents accumulation of any savings as a prerequisite to investment.[1]

In addition to the above findings is the fact that the cost of living can be much higher in the black communities than it is in other areas. In Chicago, blacks are reported to pay close to $30 a month more for housing than do whites who reside in comparable areas.[2] Oranges cost up to 15 percent more in East Harlem than in Manhattan markets just fifteen blocks away.[3] There are reasons for this, of course, and the prime one is the high incidence of crime in the ghettos. A recent study by the Small Business Administration found that the 4 percent of all businesses which are located in the ghettos accounted for 2 percent of all sales but 8 percent of all dollars lost as a result of crime.[4]

The net result of this data leads to a partial definition of our problem. There is an established income and spending cycle in the ghetto that defies breaking by the black community itself. There is little discretionary income left in the ghettos that can be channeled into savings. This means that

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[1]Ali Fatemi, "Black Capitalism as a Strategy for Economic Development of the Ghetto," University of Akron Business Review (Fall 1970), 47-48.

[2]Thompson, "Black Ownership An Analysis and a Proposal - Part I," 30.

[3]Theodore L. Cross, Black Capitalism: Strategy for Business in the Ghetto (New York: Atheneum Publishers, 1969), p. 33.

[4]Wilfred J. Garvin, "The Small Business Capital Gap: The Special Case of Minority Enterprise," Journal of Finance, XXVI (May, 1971), 449.

blacks themselves cannot provide the risk capital necessary to stimulate business development. As Fred C. Allvine has stated, "These conditions cause a 'business capital trap' that has and will continue to seriously constrain black business development unless creative programs can be found to significantly increase the capital flow into the ghetto."[1]

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[1]Fred C. Allvine, "Black Business Development," Journal of Marketing, XXXIV (April, 1970), 6.

CHAPTER III

THE BANKING INDUSTRY'S RESPONSIVENESS TO THE NEEDS OF BLACK BUSINESS

Introduction

With a fairly substantial case having been made by the preponderance of black leaders for increasing the development of black businesses coupled with the inherent capital gap existing in the black community, it is necessary next to assess the performance of the traditional, private financial institutions in meeting the financial needs of black businessmen. There are two necessary reasons for making the assessment. First, in a free-enterprise system, modern economic theory believes that Federal intervention should only be taken when the normal market mechanisms fail to allow for the free and equitable entry of producers and consumers into the economic mainstream. Second, even if Federal assistance is required to assist minority businessmen in gaining the initial viability to enter the mainstream of the competitive marketplace, to maintain viability and growth in the long run these businessmen must be able to rely on the commercial financial windows for financial assistance on a equitable basis.

This chapter will first look at the current status and viability of the black banking industry, which should be most

attuned to the needs of black businessmen. Then an assessment will be made of the majority banking industry's performance with respect to serving the needs of black businessmen. Next an example of one bank's program of special commitment to minority businesses will be presented as a potential model. Finally, three new programs undertaken by the banking industry to assist both black bankers and black businessmen will be reviewed.

Analysis of the Black Banking Industry

The history and development of the black banking industry closely parallels that of black businesses in general. Contrary to popular belief, the Freedman's Bank, which was created at the end of the Civil War to hold approximately $200,000 in unclaimed savings of black soldiers, was not a black bank at all. Although holding only deposits of black people, it was run by white trustees who were not even stockholders in the bank. The bank did prosper until 1870, when Jay Cooke's Northern Pacific bond venture failed causing a general banking panic. Within eighteen months, Freedman's lost over $2 million in deposits and was forced to cease operations.[1]

The first truly black-owned bank was the Savings Bank of the Grand Fountain, United Order, True Reformers, chartered in 1888. From that year until 1933, there were 134 financial institutions created by blacks and forty could be classified as commercial banks.[2] The average life span of these institutions

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[1] "Banking," Black Enterprise, II (October, 1971), 31.

[2] Edward D. Irons, "Black Banking - Problems and Prospects," Black Business Digest, II (December, 1971), 42.

was about nine years.[1] Although this track record was probably not too different from the total banking community, which lost nearly 14,000 banks during this period, there were only eight black banks which were able to reopen their doors after President Franklin Roosevelt's three-day banking moratorium in April of 1933.

From April of 1933 until 1947, only four new black banks were organized. Since 1947, however, the number of black banks has more than doubled. By October of 1971, there were twenty-six black-owned banks in operation and seven more are tentatively scheduled to open within the year. Unlike the older banks, which were located primarily in the South, the majority of the newer ones are being opened in the North and the West.[2]

Andrew F. Brimmer, in his capacity as a governor of the Federal Reserve Board, has had a comprehensive analysis made of the twenty-two black banks that were in existence as of late 1969. Using the Consolidated Report of Conditions and Examination Reports for all member banks, he had the Fed's examination staff make a detailed comparison of black-owned banks to all insured commercial banks.[3] As Table 2 shows, black banks comprise only .16 percent of all banks and their total assets are only .049 percent. With total deposits averaging $10 million, the typical black bank is only one-third the size of the

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[1]"Banking," 31.

[2]Ibid., p. 30.

[3]Andrew F. Brimmer, "The Black Banks: An Assessment of Performance and Prospects," Journal of Finance, XXXVI (May, 1971), 379-382.

TABLE 2

BLACK BANKS' SHARE OF THE BANKING SYSTEM IN THE UNITED STATES, 1969
(Amounts: All Banks, Billions of Dollars; Black Banks, Millions of Dollars)

Category	All Insured Commercial Banks	Black Banks	
		Amount	Percent of Total
Number of banks	13,473	22	0.163
Number of employees	904,736	834	0.092
Average per bank	67.1	41.7	62.2
Total assets	$530.7	$258.8	0.049
Total deposits	437.0	229.5	0.053
Average size of bank ($ millions)	32.6	10.4	31.9
Total capital	39.6	19.2	0.048
Total loans	286.8	130.4	0.045
Commercial and industrial	108.4	36.2	0.033
Real estate	70.3	46.9	0.067
Individuals	63.4	22.1	0.035
Memorandum	Total	Negroes (Amount)	Percent of Total
Population (millions)	203.2	22.7	11.2
Labor force (millions)	77.9	9.1	11.7
Aggregate money income ($ billions)	$600.1	$38.1	6.3
Ownerships of selected assets by households ($ billions)	970.1	18.2	1.9
Financial assets	337.1	2.3	0.7
Money in banks	164.8	1.8	1.1
Government bonds	26.9	0.3	1.2
Corporate stocks	145.4	0.2	0.1
Other assets	633.0	15.9	2.5
Farm equity	154.7	1.9	1.2
Business equity	106.4	1.3	1.2
Equity in home	371.9	12.7	3.4

Source: "The Black Banks: An Assessment of Performance and Prospects," 381.

typical bank in the country at large. The figures also show that blacks owned only about 1.1 percent of the total deposits in all financial institutions. A further analysis reveals that black banks control only .048 percent of the total capital of all banks. From this it can be implied that the black banks themselves have a pronounced capital gap.

Brimmer's examiners made other comparisons of the profitability of black banks, which indicated to him that by operating in the ghetto areas, black banks are working at a distinct disadvantage. For example, in 1968, operating costs absorbed 93 percent of operating income of black banks compared to an average of 78 percent for all member banks. Wages accounted for nearly one-third of these operating costs compared to only one-quarter for the typical banks. Brimmer feels that one of the big reasons why labor and total operating costs are higher for black banks is the larger number of smaller accounts that they must service. Due to these higher operating costs, black banks could pay at that time only an average of 3.1 percent on time and savings accounts compared to 4.4 percent by the typical bank.[1]

As to overall efficiency, Table 3 shows the trend between 1967 and 1970 in the areas of asset evaluation and an overall composite rating. With regard to the Composite Rating, a mark in Group Rating Class 1 implies that a bank was strong in all three areas of capital adequacy, asset quality and management performance. A mark in a lower Group Class Rating 2 implies

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[1] Ibid., pp. 383-387.

TABLE 3

ASSET EVALUATION AND COMPOSITE RATING OF BLACK BANKS, AND A SAMPLE OF FEDERAL RESERVE STATE MEMBER BANKS, 1967, 1968, AND 1970

Category	Total	Group Rating Class			
Composite Rating		1	2	3	4
F. R. Member Sample (1967)					
Number	677	439	211	24	3
Percent	100.0	65.0	30.8	3.6	0.6
Black Banks					
1967 Number	15	3	7	4	1
Percent	100.0	20.0	46.6	26.7	6.7
1968 Number	15	4	5	6	0
Percent	100.0	26.7	33.3	40.0	0.0
1970 Number	22	12	5	5	0
Percent	100.0	54.4	22.8	22.8	0.0
Asset Rating		A	B	C	D
F.R. Member Sample (1967)					
Number	677	536	106	25	10
Percent	100.0	79.5	15.7	3.7	1.1
Black Banks					
1967 Number	15	5	6	3	1
Percent	100.0	33.3	40.0	20.0	6.7
1968 Number	15	7	3	4	1
Percent	100.0	46.6	20.0	26.7	6.7
1970 Number	22	12	4	6	0
Percent	100.0	54.4	18.2	27.4	0.0

Source: "The Black Banks: An Assessment of Performance and Prospects," 393.

that a bank might be strong in two of the three areas but weak in the third area.[1] As can be seen, black banks as a whole are improving with respect to both the Composite Rating, with an increase of 34.4 percent in the four years, and the Asset Rating, with an increase of 21.1 percent. Still, although these figures appear optimistic, Brimmer cites other figures that tend to dampen this optimistic trend.

Black banks are on the average setting aside 7.3 percent of operating expenses as a provision for loan losses whereas the typical bank requires only a 2.1 percent loss reserve. Brimmer believes that this is directly related to the high risks of doing business in the ghetto with high unemployment, low family income and high business failure rates. He also cites as internal factors, which lessen the performance of black banks, the lack of adequate capital, poor asset quality and an insufficient managerial expertise of black bankers themselves.

In a more detailed breakdown of the Composite Rating, an analysis of management performance revealed that the percentage of black banks receiving a poor rating in this area increased from 20 percent in 1967 to 43 percent in 1970.

Brimmer believes that due to the handicaps indicated above, black banks promise little potential for being viable financial instruments in the commercial development of the ghetto. Most black banks do not concentrate their loans in the ghetto, and he feels they are wise not to do so. In the area

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[1] Ibid., p. 392.

of financing black businesses, he found that commercial and industrial loans comprised only 8.9 percent of the investment portfolio of the average black bank compared to a 22.2 percent rate for the typical bank. Loan to deposit ratios in general are 17 percent lower for black banks than for the typical member bank.[1] As Table 4 shows, black banks on the average made 78.2 percent of their loans to local borrowers, but this accounted for only 40.7 percent of total assets.

In summarizing his findings, Brimmer is strongly convinced that the proliferation of more black banks in the belief that they can make a large contribution to the financing for economic development in the ghetto areas is something that should not be encouraged, since by all indications they cannot fulfill this goal. He further believes that if the founding of more black banks will be a stimulus to racial pride, then the motive is fine, "But under those circumstances, most of the black banks might be viewed primarily as ornaments -- that is, as a mark of distinction or a badge of honor which provides a visible symbol of accomplishment."[2]

Brimmer's unfortunate choice of words in summarizing his analysis of black banks has probably brought more wrath upon him by black business leaders than if he had announced that he personally was going to lead a draft to nominate Lester Maddox as the Democratic presidential candidate in 1972. Coming as

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[1] Ibid., pp. 387-397.

[2] Ibid., p. 402.

TABLE 4

SELECTED CHARACTERISTICS OF LOANS OUTSTANDING AT BLACK BANKS AS SHOWN IN EXAMINATION REPORTS, 1970
(Accounts in Thousands of Dollars; Deposit Size in Millions of Dollars)

Category	Total	Size of Bank: 10 to 50 million	Size of Bank: Under 10 million
Total assets	264,563	193,126	71,437
Total loans			
Amount	137,535	94,295	43,240
Percent of total assets	52.0	48.8	60.5
Loans to local borrowers			
Amount	107,552	77,165	30,387
Percent of total assets	40.7	40.0	42.5
Percent of total loans	78.2	81.8	70.3
Loans to other borrowers			
Amount	29,963	17,130	12,833
Percent of total assets	11.3	8.9	18.0
Percent of total loans	21.8	18.2	29.7
Federal funds sold	15,875	7,400	8,475
Percent of total loans	11.5	7.9	19.6
Participations purchased	7,888	3,530	4,358
Percent of total loans	5.7	3.7	10.1
Brokers loans, commercial paper, bankers acceptances	6,200	6,200	--
Percent of total loans	4.5	6.6	--
Commercial and industrial loans			
Amount	36,214	20,727	15,487
Percent of total assets	13.7	10.7	21.7
Percent of total loans	26.3	22.0	35.8
Local borrowers	28,326	17,197	11,129
Percent of commercial and industrial loans	78.2	83.0	71.9
Participations purchased	7,888	3,530	4,358
Percent of commercial and industrial loans	21.8	17.0	28.1

Source: "The Black Banks: An Assessment of Performance and Prospects," 398.

it did from the most prominent and potentially influential black banker in the country, the one black man who could do more to help the black banking community than any other, many black business leaders feel that Brimmer has seriously and possibly irreparably shattered the slight degree of confidence that was beginning to emerge in this new fledgling industry.

Among the more prominent critics of Brimmer's assessment have been Samuel R. Pierce, General Counsel, U.S. Treasury Department; Dunbar S. McLaurin, economist, educator and president of a firm of ghetto economic consultants; and Edward D. Irons, former professor at Howard University and Executive Director of the National Bankers Association, and currently filling the Mills R. Lane Chair in Banking and Finance at Atlanta University.

Pierce's main argument with Brimmer's analysis is that it compared black banks to all banks only with respect to size but not age. He believes this is an unfair comparison since most of the black banks are newly chartered and are bound to have a less efficient performance record during their first few years of operation. For example, new banks usually cannot invest their funds in loans as rapidly as deposits are created and this accounts for the higher reliance on investments in Government securities or participation with other banks in carrying loans outside of their own normal marketing area. As they stabilize their financial structure and gain more maturity in managing their total portfolios, Pierce feels these black banks will turn more toward their own normal markets for the heaviest investments in lending. He feels that regardless of their current

comparative ratings, Brimmer has underestimated the influence these banks are making in the ghettos since they are providing loans to black businessmen that were not being provided by white-owned banks. Finally, he feels that the emergence of black banks has caused some white-owned banks to be more liberal in their lending policies to black businessmen.[1]

McLaurin feels that if Brimmer is going to compare the performance of black-owned banks to white-owned banks then he should do just that. By this he means that the white-owned banks selected should be of the same size, age and operating environment, e.g., the operating environment should mean the same cities in which black-owned banks are located and the same type of neighborhood business. McLaurin chides Brimmer for stating that "Blacks must accept tokenism in banking and finance." He feels that we need not only to strengthen current black banks, but that a massive program to create "instant banking" must be started so that there are at least 150 black banks in operation at the end of the next five years.[2]

Irons does not criticize Brimmer by name but in his defense of the black banking industry, he does address himself to most of Brimmer's criticisms. He feels that to properly assess black banks one must first remember that these banks represent a new, emerging industry and as such they are facing the same problems that are common to any new industry. To him,

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[1]Samuel R. Pierce, Jr., "Black Banks CAN Be Vital Instruments," Banking, LXII (March, 1971), 33, 85.

[2]McLaurin, "White Brimmerism or Black Capitalism," 44.

there is no real reason why we need black banks, per se, but until the general banking industry can, or will, respond adequately to the needs of the black community, black banks provide one of the only viable means to help satisfy the capital needs of black businesses. He acknowledges the fact that black banks are located in the lowest income areas, which hinders their growth, and that black bankers at present do not have an adequate degree of managerial experience. But he argues that unless we have a black banking industry, there will not be a place for future black banks to really learn their trade.[1]

There are some who would argue this point with Irons stating that the majority business community is engaged in an intensified effort to train and place black people in higher levels of responsibility within the majority banks. Yet it was not until 1972 that a black man was chosen to serve in a top management position in a white-owned bank in the District of Columbia. On January 11, 1972, the National Bank of Washington, the city's third largest bank, announced that Emmett J. Rice had been named as senior vice president for planning and development. Rice, who holds a doctorate in economics from the University of California at Berkeley, was deputy U.S. executive director at the World Bank, has held a variety of international financial agency positions and is executive director of the Mayor's Economic Development Committee

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[1]Irons, "Black Banking - Problems and Prospects," 43-44.

(MEDCO) in the District of Columbia.[1] He would appear to be qualified for his new position.

Irons sums up the prospects of black banks in two words, "societal contingency." He feels that black banks, "are a mirror of contemporary American society, in the same manner as black doctors, black lawyers, black businessmen or black economists." He feels that they all are a product of their heritage, and face the same past inequities and present deterrents to viability. All possess the same potential for future prosperity and black banks can become a sound financial industry. But to achieve this potential they must be freely allowed to grow and develop. Further, Federal, state and local governments must begin to use black banks as a depository in the same manner as they use other banks. Finally, black banks need additional venture capital and greater managerial development programs so that they can become competitive in the mainstream of the nation's financial community.[2]

Majority Banking Assistance to Black Business

It is generally conceded by the majority banking community itself that it has not been overly responsive to the financial needs of minority entrepreneurs. Much of the reason for this is due to the traditionally conservative nature of the industry with regard to the factor of risk, but an element of discrimination has been present as well. For example, it is

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[1]"Rice Named To High Post With NBW," The Washington Post, Jan. 11, 1972, sec. D., p. 6.

[2]Irons, "Black Banking - Problems and Prospects," 44-45.

reported that in order for John H. Johnson, who owns Ebony and Jet magazines as well as other successful enterprises, to obtain a $500 business loan he had to tell a bank's lending officer that the money was to be used to finance a vacation.[1]

Although this is an extreme case in point, and has not been authenticated by this writer, it does indicate the type of frustration potentially successful black businessmen have had in dealing with white-owned banks. Statistics gathered in the District of Columbia in 1967 revealed that the best estimate of the total number of direct commercial loans (direct implying that there was no use of a Federal guarantee such as can be provided by the Small Business Administration) which were made to minority businessmen totaled between $150,000 to $200,000. When compared to the nearly $345 million in loans made to white businessmen during that same year, the white businessmen received 1,725 times more money than did the black businessmen.[2]

While statistics of this nature sound extremely impressive, they really say very little more than the fact that whites got a lot more money than blacks in business loans. It would really be significant to know how many black businessmen were turned down for a business loan when they presented as sound a financial plan to a white bank's lending officer as a white businessman who was granted a loan. Unfortunately, such data has not been made available, or at least not to the public, by

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[1]Thompson, "Black Ownership An Analysis and a Proposal - Part I," 32.

[2]Mayor's Economic Development Committee, Overall Economic Development Program for Washington, D.C., p. VII-2.

the banking industry. Even if this data were available the story would still be incomplete since many black businessmen, or potential businessmen, have so little confidence in the concern of the majority banking industry for the future of black business development that they never even bother to approach a bank for financial assistance.[1] Despite this lack of total information by which the true financial needs of all black businessmen can be measured more accurately, there is enough data available to substantiate the belief that black businessmen cannot get the financial assistance they need from the majority-owned banking industry.

A study by the Office of Planning, Research and Analysis of the Small Business Administration (SBA) in 1968 revealed that in order to reach equality, in terms of having the same percentage of business enterprises in proportion to their percentage of the country's total population, minority groups need 600,000 total enterprises which would require in excess of $40 billion in equity financing. Although these figures can easily be misleading, since they assume that there are 300,000 well-qualified potential entrepreneurs just waiting in the wings for a source of initial seed-capital, an SBA survey of black households in thirty-three cities did reveal that 58 percent of the people had considered going into business for themselves but 72 percent cited a lack of financing as their principle deterrent. Of the

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[1]Alfred L. Morris, "The Problem of Risk Capital in Ghetto Areas," Black Business Digest, I (May, 1971), 42.

total sample, 44 percent had incomes of over $15,000 and 46 percent had from one to three years of college.[1]

SBA also made a study of the degree of participation the banking community has made with respect to investments in minority enterprises using the SBA loan guarantee program. This program provides upwards of a 90 percent Federal guarantee on all business loans made to minority businesses. A loan participation index was devised so that a banking district would receive a rating of 100 if its share of all loans to minority persons was the same percentage as the minority population of that district. Table 5 shows the results of the ratings for fiscal year 1970. As might be expected, those districts that had the highest minority populations as a percentage of total population tended to show a lower density index than those districts with smaller minority populations. Table 6 shows the growth rate of participation by district between fiscal year 1969 and fiscal year 1970. Although the data do not provide any clear cut indicators as to the future trends in minority lending, they do show that certain areas, like Washington, D.C., have a long way to go in serving the needs of black business.[2]

The main reason the majority banking community has not been responsive to the needs of minority entrepreneurs can be summed up in one word -- tradition. Tradition dictates that bankers will be conservative risk takers and not speculators.

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[1] Garvin, "The Small Business Capital Gap: The Special Case of Minority Enterprise," 448-450.

[2] *Ibid.*, pp. 451-454.

TABLE 5

LOAN DENSITY INDEX AND MINORITY POPULATION RATIO BY SBA DISTRICT
Fiscal Year 1970

District	Density Index	Percent Minority Population	District	Density Index	Percent Minority Population
Boston	792	3.4	Marshall	84	37.6
Syracuse	551	3.4	Houston	78	27.6
Denver	446	14.8	Los Angeles	70	20.9
Pittsburgh	349	4.2	New York City	67	20.9
Indianapolis	242	6.7	Oklahoma City	55	11.9
Seattle	226	6.4	Jacksonville	53	19.6
Kansas City	216	8.1	Albuquerque	52	49.9
Newark	214	12.4	Richmond	51	23.0
Detroit	205	11.7	Birmingham	51	29.4
Hartford	193	8.3	Charlotte	50	25.1
Chicago	169	14.6	San Antonio	47	59.2
San Francisco	158	18.3	Baltimore	45	19.0
Cleveland	147	8.3	Atlanta	43	27.6
Louisville	139	7.3	Nashville	43	16.7
Miami	114	19.4	Dallas	42	18.0
San Diego	110	29.3	Washington, D.C.	33	27.1
Columbus	98	8.8	Jackson	25	41.3
Phoenix	97	28.2	Little Rock	23	20.5
Philadelphia	97	11.8	Columbia	19	33.4
St. Louis	92	14.4	New Orleans	16	31.9

Source: "The Small Business Capital Gap: The Special Case of Minority Enterprise," 452.

TABLE 6

LOAN DENSITY INDEX AND BANK PARTICIPATION GROWTH RATE BY SBA DISTRICT
Fiscal Year 1969 to Fiscal Year 1970

District	Loan Density Index	Participation Growth Rate (percent)	District	Loan Density Index	Participation Growth Rate (percent)
Boston	792	42	Marshall	84	267
Syracuse	551	15	Houston	78	41
Denver	446	68	Los Angeles	70	98
Pittsburgh	349	9	New York City	67	-46
Indianapolis	242	8	Oklahoma City	55	300
Seattle	226	71	Jacksonville	53	6
Kansas City	216	-10	Albuquerque	52	36
Newark	214	86	Richmond	51	- 6
Detroit	205	79	Birmingham	51	14
Hartford	193	-14	Charlotte	50	34
Chicago	169	92	San Antonio	47	130
San Francisco	158	77	Baltimore	45	-64
Cleveland	147	7	Atlanta	43	-14
Louisville	139	64	Nashville	43	40
Miami	114	- 8	Dallas	42	36
San Diego	110	108	Washington, D.C.	33	6
Columbus	98	-45	Jackson	25	5
Phoenix	97	38	Little Rock	23	0
Philadelphia	97	- 8	Columbia	19	-19
St. Louis	92	14	New Orleans	16	140

Source: "The Small Business Capital Gap: The Special Case of Minority Enterprise," 453.

To a degree this is as it should be since the country can ill afford a financial crisis like the one that occurred during the Great Depression. Since 1933, the nation's banks have been looked upon as the cornerstones of our financial stability and have tried to maintain a posture of underlying conservatism, relying primarily on the Federal Reserve Board and the U.S. Treasury for their overall source of financial policy. The Federal Reserve Board itself has resisted attempts to enter into the picture of possibly creating secondary markets for the intermediate and long-term paper of small business concerns. In a report on this subject, the Fed concluded that:

> A possible type of credit accommodation not provided for in the redesigned window is long-term credit to meet the needs of banks serving perennial credit-deficient areas or sectors . . . the solution to this problem does not properly lie within the scope of discount-window operations . . . More direct and fundamental answers to the credit-deficit problem are believed to lie in the improvement of secondary markets for bank assets and liabilities.[1]

When one attempts to apply the traditional techniques for analyzing credit risk to a normal black business loan, the outcome seldom results in favor of the businessman. These traditional techniques are based on an established set of criteria, which includes:

> . . . the competence and character of management; potential for stability or growth of earnings; growth in sales; quality of assets; comparative operating ratios; past performance on loans; the amount of

[1] Ibid., p. 448.

> personal equity in initial capitalization; and the amount and quality of market competition.[1]

The black businessman operating in the ghetto can seldom measure up to the degree required in each of these criteria to obtain a business loan.

Don H. Alexander, a lending officer at the Seattle First National Bank and former member of the American Bankers Association's Urban Affairs Task Force on Minority Lending, has defined six problem areas which have tended to prohibit banks from helping to fill the black capital gap. First is the lack of communication between middle and top management within the bank. The bank president may publicly announce increasing support to minority enterprise but the word never filters down to the lending officers in the form of revised and liberalized policies. Second is the bank's reluctance to look at the potential minority entrepreneur in other than the traditional manner. Bankers have failed to realize that black businessmen operate in a different environment and with an inferior business experience level than their white counterparts. Third, Alexander feels that most banks are still out of tune with the times and unaware of the magnitude of the problems in the ghettos. Fourth, bank examiners themselves may tend to override a banker's desire to assist minority loan-seekers by highly restrictive portfolio evaluation standards. Fifth is the fear many bankers have of the negative reaction they will receive from their own shareholders if they become

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[1]Peter F. McNeish, "Where Does the Money Come From?", Chapter 7 of Black Economic Development, ed. by W. F. Haddad and G. D. Pugh, The American Assembly (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1969), p. 86.

involved in ghetto financing. Finally is the inherent communications gap that exists between the banks and the residents of the ghetto. Although a bank may publicly announce a new policy making it easier for blacks to obtain loans, the words will go unheard by the masses unless it is relayed to them by a member of the black community.[1]

First Pennsylvania's Minority Lending Program

Although the above argument holds true for the vast majority of banks, there are certain individual banks that have broken, or at least bent, the yoke of tradition and demonstrated their belief that a bank cannot be considered successful unless it does become socially as well as financially involved in its community. One of the leaders of this new movement is the First Pennsylvania Banking and Trust Company.

The main advocate of this new approach in banking philosophy is First Pennsylvania's president, John Bunting. Bunting feels that real social involvement of some degree should be a part of every corporation's day-to-day operations if it can possibly afford to do so. He states that this involvement usually implies funds, and the most obvious deterrent to the use of company profits is that by so doing, the corporation will be guilty of not maximizing the profitability of the firm to its owners. While he acknowledges that this is an important and obvious consideration, he believes that on the whole, shareholders

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[1]Don H. Alexander, "A Black Banker Speaks Out," Black Business Digest, I (March, 1971), 45-46.

will not condemn management for pursuing such a policy. In fact he feels that just the opposite will occur, since if properly informed of the reasons for such involvement, shareholders will applaude management and take personal pride in their company's social achievements. Of course this is all predicated on the fact that the company's overall profitability is gaining well.[1]

The program began in June of 1966 when a group of black businessmen approached the bank with an earnest request that the bank make more loans available to black businesses. The bank responded by setting up a separate office for reviewing black loan requests and assigned one of its best commercial loan officers to this office. In addition to this the policy was established that a potential loan could not be rejected without going through senior management.[2] So we can see at this point that First Pennsylvania had overcome most of the problems Alexander found that banks must resolve before they can deal realistically with black business loans; that is, top management support and clear-cut lending policies.

From 1966 to mid-1971, First Pennsylvania had made over 350 loans in excess of $7.6 million and has experienced a net loss rate during this period of 7 percent, far less than it had anticipated. Since its first involvement in 1966, First Pennsylvania has established a Metropolitan Economic Development

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[1]John Bunting, "Banking," Black Business Digest, II (December, 1971), 30.

[2]Elmer Young, Jr., "Measuring a Commitment," Black Business Digest, II (January, 1972), 48.

Unit within the bank which now coordinates black business loans for all branch banks and performs a vital function of counseling all rejected loan applicants as to where the weaknesses are in their plans and how an applicant can best overcome them. The bank also has a Business Experience Education Program that acquaints high school students with the banking industry and provides part-time employment for them. The total program has been considered a financial as well as a social success.[1]

With the economic problems that have plagued most business firms during the last few years, and especially the last half of 1971, Bunting's call for more social involvement will still fall mainly on deaf ears in spite of the resounding success of his bank's program. But there are signs that corporations and their owners are beginning to recognize that a corporation's goals and objectives must include more than the profit motive. First Pennsylvania's success in their program of assisting minority enterprises certainly bears consideration as a possible model for other institutions to study.

New Banking Programs to Assist Black Bankers and Businessmen

Although the banking industry may not be responding as quickly to the needs of black businessmen as some would wish, there have been some significant recent developments that should help to strengthen black banks as well as provide more direct assistance to minority businessmen. One of the leading

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[1] Ibid., p. 49.

organizations in stimulating greater banking commitments has been the American Bankers Association's (ABA) through its Urban Affairs Committee.

The Urban Affairs Committee was established in 1968, "to initiate and coordinate the banking industry's program to help solve urban problems." The Committee is composed of sixty senior executives of banks serving large metropolitan areas in the country, and is chaired by Thomas W. McMahon, Jr., executive vice president of The Chase Manhattan Bank. Two of the more viable programs the Committee has undertaken are the formation of the Minbanc Capital Corporation (MINBANC) and the Billion Dollar Goal.[1]

MINBANC is a non-diversified, closed-end investment company, incorporated in Delaware on June 18, 1971, whose goal it is to be able to supply $10 million in equity capital to viable minority-controlled banks. MINBANC's stock eventually will be offered to nearly all of the 14,000 members of the ABA. The reason for MINBANC is the results of a detailed study of twenty-three minority-owned banks in comparison with the typical member bank of similar size, in terms of total deposits. The study showed that minority banks are nearly twice as highly leveraged, in terms of total liabilities to liquid capital base, as the typical member bank. This dangerously high leverage ratio of

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[1] "ABA's Urban Affairs," Black Business Digest, II (December, 1971), 33.

29.7 to 1 clearly indicated that minority banks have a serious capital shortage.[1]

Minority banks will have to have been in operation for at least three years before obtaining MINBANC assistance, since the ABA wants to be sure that these banks have achieved some viability on their own. Capital funds will be made available both directly, through buying investment securities of the minority banks, and indirectly through investments in other sources which will cause funds to flow to the minority banks. Ordinarily MINBANC will not acquire any voting securities in the minority banks. MINBANC itself will receive certain administrative services from the ABA. Shares in MINBANC will sell for $500 each and no purchases may own more than 5 percent of the total shares outstanding.[2]

Since MINBANC is just beginning to make initial offerings, no information is available to indicate when, or if, it will be fully capitalized at its goal of $10 million. Although this sum is by no means a large sum, still it represents a beginning of a change in attitude that white bankers are taking toward their black counterparts.

Another program to assist minority owned banks is President Nixon's $100 million Minority Bank Deposit Program, begun on October 2, 1970.[3] Initiated by the Department of the

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[1]Thomas W. McMahon, Jr., "Minority Banks," Black Enterprise, II (October, 1971), 34.

[2]"The Minbanc Capital Corp. $10 Million to Minority Owned Banks," Black Business Digest, II (December, 1971), 39-40.

[3]"New Funds Benefiting Inner City Institutions," Commerce Today, II (November 15, 1971), 9-10.

Treasury and the Department of Commerce, with the assistance of the National Bankers Association, the program was designed with a goal of $35 million new deposits in minority banks by Federal agencies and $65 million from the private sector within one year. On September 30, 1971, the nation's 35 minority-owned banks reported an increase in deposits of $155.5 million during the year. Total combined deposits of these banks now equals $552 million, nearly a 40 percent increase over the $396.5 million figure reported a year ago. More than $100 million of these deposits has been directly attributed to this program.[1]

The other ABA program, called the Billion Dollar Goal, is designed to have commercial banks commit at least $1 billion in new financial assistance to minority businessmen during the inclusive five year period of 1971 to 1975. The goal was derived from a 1970 survey of 188 banks, made by the Urban Affairs Committee, as to their future plans for assisting minority businesses. The survey revealed that 81 percent of the respondents are already planning increased minority lending programs, especially of the soft loan variety. During the year ending June 30, 1969, about one-half of these banks had made loans totaling nearly $100 million to over 21,000 minority businessmen. Based on this record, the Urban Affairs Committee doubled this amount and extended it for five years to achieve the $1 billion figure. Considering that the number of banks surveyed represented only about 1 percent of the total banking community, this figure

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[1]"Nixon's $100 Million Goal For Minority Banks Exceeded," Black Business Digest, II (January, 1972), 47.

is actually somewhat conservative. The ABA intended it to be so, since it recognizes that past "overpromises" to minority groups has only led to increased levels of frustration.

To stimulate local banking action to meet this goal, the Urban Affairs Committee has chosen to focus on 50 key cities which represent those areas of highest concentration of minority businessmen. Seminars will be held with local bankers in each of these cities to not only encourage participation in this program but also, hopefully, to encourage local bankers to develop local urban affairs committees to bring increased attention to the needs for a coordinated banking effort in all areas of urban development.[1]

None of the above programs can provide the total funding the minority businessmen feel they can now use, yet there is a significant change in attitudes prevalent in the intent and direction of these programs that did not exist even five years ago. The best estimates of an ABA survey made in 1971 on bank lending performance of 1970 indicate that approximately $160 million business loans were made to minority businessmen in 1970. Although the total amount may or may not be significant, the data from which it was derived shows that the rate of lending increased 17 percent between the first six months and the second six months, which does indicate a significant and encouraging trend.[2]

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[1] "Banking Industry Plans $1 Billion in Loans to Minority Businesses by 1975," Black Business Digest, II (December, 1971), 34, 38.

[2] "A Banking Survey," Black Business Digest II (January, 1972), 56.

CHAPTER IV

FEDERAL FINANCIAL ASSISTANCE TO MINORITY BUSINESS

Introduction

The purpose of this chapter is to review the growth and development of Federal financial assistance programs to minority enterprises and to describe how the major lending programs operate. Since the Small Business Administration (SBA) has provided the primary financial assistance to minority enterprises, this chapter will first discuss the evolution of the SBA assistance programs up to 1968. Next the full emergence of minority enterprise assistance from 1968 to the present will be reviewed. Then the mechanics of SBA's principal loan programs will be outlined. Finally, a brief assessment of the performance of these programs will be made.

SBA Minority Business Assistance Prior to 1968

The SBA was created in 1953, in an attempt to combine the activites of two other Federal agencies, the Small Defense Plants Administration (SDBA) and the Reconstruction Finance Corporation (RFC), into a single, integrated agency. The function of the SDPA was to assist small but strategic former defense businesses in the successful transformation from defense-oriented to consumer-oriented product lines. The functions of the RFC were to make business loans to small

business concerns as well as to assist victims of floods and other disasters.[1]

The SBA was given the functions of these two agencies plus a more extensive scope of operations than its predecessors. In establishing SBA, the law stated:

> It is declared policy of the Congress that the Government should aid, counsel, assist, and protect insofar as possible the interests of small business concerns in order to preserve free competitive enterprise, to insure that a fair proportion of the total purchases and contracts for supplies and services for the Government be placed with small business enterprises, and to maintain and strengthen the overall economy of the Nation.[2]

So in effect the Congress established this new agency to be the chief Federal advocate for all small businessmen, and in a stronger capacity than either of its predecessors had enjoyed.

The actual definition of a small business with respect to size can be relatively complex and is not considered relevant to this study. However, when SBA was created in 1953, it was estimated that nearly 96 percent of the over 4 million total businesses in existence throughout the nation at that time were defined as being "small" and eligible for SBA assistance.[3]

Although its charter clearly gave SBA the opportunity to assist minority businesses, in its early years little effort was made in this direction. No criticism of the SBA is intended by this comment; it just reflects the tempo of the times during

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[1]U.S. Small Business Administration, 1st Semi-Annual Report, 1953 (Washington, D.C.: Government Printing Office, 1954), p. 1.

[2]Small Business Act, PL 163, sec. 215 (1953).

[3]U.S. Small Business Administration, 1st Semi-Annual Report, p. 7.

the late 1950's and early 1960's. The fact is that SBA was having a difficult time trying to help white small businessmen achieve a greater degree of viability.[1] By 1964, however, the civil rights issue began to receive much more political interest and with the passage of the Civil Rights Act in 1964, a new social and political commitment was made to our minority citizens by the Federal government. While this act was not economically oriented, its companion bill, the Economic Opportunity Act of 1964, made a firm Federal financial commitment, which eventually was applied to minority businesses. Title IV of the Act states:

> It is the purpose of this title to assist in the establishment, preservation, and strengthening of small business concerns and improve the managerial skills employed in such enterprises, with special attention to small business concerns (1) located in urban or rural areas with high proportions of unemployed or low-income individuals, or (2) owned by low-income individuals; and to mobilize for these objectives private as well as public managerial skills and resources.[2]

Even though a mechanism had been established by this legislation to give some Federal financial assistance to minority businessmen, no real attempt was made to use it for this purpose until 1966. One SBA official, who worked in this program during this early period, said that the Economic Opportunity Loan Program (EOL) really did not provide much assistance at the start because the Office of Economic Opportunity's (OEO) main emphasis was on solving the unemployment issue and not minority

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[1]John Moore, private interview at U.S. Small Business Administration, Washington, D.C., November, 1971.

[2]Economic Opportunity Act, U.S. Code, Vol. XLII, Sec. 2901 et. seq. (1964).

businessmen's problems.[1] Loan money, which was provided in individual sums of up to $25,000 for a maximum of fifteen years, was given only to going concerns. Berkeley Burrell, director of the National Business League, believed that by following this policy, OEO was "looking for the impossible man--a person who has (1) management ability, (2) good credit, (3) demonstrated ability to repay, and (4) who is in poverty."[2] The EOL program did not begin to become even remotely viable until SBA was given full cognizance over it in 1966.[3]

Before this, however, there was an informal program started by SBA in 1964, entitled the "6 by 6 Plan," which allowed "disadvantaged potential entrepreneurs" to borrow up to $6,000 for a maximum term of six years to start up a small business.[4] While being meager in amount, this did herald the first direct attempt by the Federal government to provide venture, or seed, capital to potential minority businessmen. In summary, though, it can be said quite safely that there were no Federal programs actively working to assist minority businessmen prior to 1968.

SBA Minority Business Assistance Since 1968

The year 1968 will be remembered for some time as the one in which the racial crisis in our country reached it most vicious

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[1]J. Moore, private interview.

[2]"Small Business Loans," New Republic (September 24, 1966), p. 9.

[3]J. Moore, private interview.

[4]U.S., Congress, Senate, Select Committee on Small Business, statement before that Committee by Thomas S. Kleppe, Administrator, Small Business Administrator, 92nd Cong., 1st sess., Oct 20, 1971, p. 1.

and devastating peak of activity. As discussed previously, the issue of Black Capitalism was raised and the Nation faced a serious moment of choice. The National Advisory Commission on Civil Disorders advised that "an extreme social and economic polarization" was taking place in our country. In its U.S. Riot Commission Report of 1968, the Commission stated in part that:

> To continue present policies is to make permanent the division of our country into two societies: one, the largely Negro and poor, located in the central cities; the other, predominantly white and affluent, located in the suburbs. . . . If the Negro population as a whole develops even stronger feelings of being wrongly 'penned in' and discriminated against, many of its members might come to support not only riots, but the rebellion now being preached by only a handful.[1]

If the above declaration sounds threatening, that is exactly the impression it was trying to make. For 1968 was also a national election year and the continuation of the race riots that were sweeping the country at the time could only result in political disaster to many incumbents.

President Johnson, looking to the SBA as one possible source of solution, appointed Howard J. Samuels, former Undersecretary of Commerce and successful businessman in his own right, as Administrator of SBA in July of 1968. It was through this appointment that the Federal government's Minority Enterprise Program was launched and with it, a much more meaningful and direct commitment to the needs of minority businessmen.[2]

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[1]Burtt, "Reading For Proof," p. 9.

[2]U.S. Small Business Administration, Office of Minority Enterprise, Minority Business Development (Washington, D.C.: Small Business Administration, 1971). (mimeographed.)

Two months after he assumed office, Samuels announced the creation of "Project OWN," A program designed to concentrate on creating the establishment of minority-owned retail and service trade businesses, primarily of the franchise type, in twenty-eight cities.[1] Under Project OWN, Samuels took existing legislation governing loans to small businesses and used it, for the first time, in a concentrated effort to assist minority businesses. The emphasis was on SBA's loan guarantee program, whereby SBA can guarantee up to 90 percent of a commercial bank's loan to a minority businessman, or $350,000, whichever is less.

Samuels' program relied on use of the existing commercial channels of finance, and to ensure that support was forthcoming, he began an energetic tour of the country talking personally to many of the country's leading bankers and businessmen. In fiscal year 1968, the SBA had made loans to minority businessmen totaling $41.3 million. By the end of fiscal year 1969, this amount had reached $104.6 million.[2]

Just as important as the size of the loans Samuels produced was the change in attitudes that he was able to make. Both the Federal Deposit Insurance Corporation and the Comptroller's Office issued instructions to their respective examination staffs to look favorably on Project OWN and not to discourage a bank's participation in this program as long as the bank's

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[1]U.S. Small Business Administration, Press Release, September 4, 1968.

[2]U.S., Congress, Senate, Select Committee on Small Business, statement before the Committee by Thomas Kleppe, pp. 3-6.

overall condition was satisfactory.[1] The American Banks Association also fully endorsed Project OWN and encouraged its members to participate in the program as actively as they could.[2]

With the change in Administration as a result of the presidential election of 1968, Samuels' tenure with SBA became short-lived. In his place President Nixon appointed Hilary Sandoval, a 38 year-old Mexican-American small businessman from El Paso, Texas, who had been that city's Republican mayoral candidate. While many people felt that Sandoval was a man of good intentions, he was not attuned to the Federal bureaucracy which keeps Washington operating and he lacked experience in dealing with an organization of the size of SBA.

Philip Pruitt, his appointee as Assistant Administrator for Minority Enterprise, resigned within four months and was publically critical of the President's commitment to minorities. Another Sandoval appointee, Albert Fuentes, was indicted and convicted of having engaged in a shakedown of a San Antonio ornamental metal works in return for his approval of a $100,000 SBA loan.[3] These two incidents placed both Sandoval and the SBA in a bad light. Business Week reported in July of 1970, that Sandoval was in trouble with both the President and the Congress.[4] Sandoval resigned for reasons of health in late 1970, and in his

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[1] "Financing Minority Business," p. 28.

[2] "Project OWN Gets Going," Banking, LXI (February, 1969), 26.

[3] "Financing Minority Businesses," pp. 28-29.

[4] "Sandoval Stands Siege at the SBA," Business Week, July 18, 1970, pp. 61-62.

place President Nixon appointed Thomas S. Kleppe, a former Congressman from North Dakota and the president of a successful household products manufacturing company.[1]

At the same time that Sandoval was beginning to run into trouble, President Nixon issued an Executive Order, on March 5, 1969, which he hoped would help give more direction and coordination to the total minority business development efforts of the Federal government. By this Executive Order, the President's Advisory Council on Minority Business Enterprise was created.[2] The council was charged with the task of developing a blueprint for:

> . . . a national strategy that would ensure that minorities assume a significant role in developing, owning, and managing viable businesses during the decade of the seventies.[3]

The Council was composed of eighty-five persons, who represented both the majority and minority business and financial communities.

By this same Executive Order, the President created the Office of Minority Business Enterprise (OMBE), in the Department of Commerce, under the personal direction of Commerce Secretary Maurice Stans. There appear to be three reasons for the President's move to involve Commerce in the minority program. First, since the issue was business and not just small business

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[1] "Financing Minority Businesses," p. 33.

[2] U.S., President's Advisory Council on Minority Business Enterprise, Minority Enterprise and Expanded Ownership: Blue-for the 70's (Washington, D.C.: Government Printing Office, 1971), p. iv.

[3] Ibid., p. iv.

it was logical to have the Administration's prime big business-oriented agency bring its resources and influence to bear on the problem. Secondly, since Commerce has a more powerful voice in the total business community than any other single agency, it was in a better position to help convince the majority business community to give more assistance to minority businesses. Thirdly, the 116 Federal minority programs administered at that time by twenty-one separate agencies was totally uncoordinated and overlapping in their individual attempts to aid minority businesses.[1] Whether OMBE can become a viable means of better coordinating the Federal government's efforts toward assisting minority businessmen or merely add another layer of administration between these programs and the people they are supposed to help cannot as yet be determined.

The SBA's Current Minority Loan Programs

The SBA has two primary loan programs which can provide direct financial assistance to minority businessmen. These are the Economic Opportunity Loan (EOL) Program and the 7(a), or Operation Business Mainstream Program, In addition to these loan programs, SBA has a loan program to help firms that are displaced as a result of Federally-aided urban renewal and other construction projects. This program will not be addressed in this study since it applies to a rather specific category of businesses. The final area of financial loans are provided

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[1] "Financing Minority Businesses," pp. 29-30.

indirectly to minority businessmen through Development Company Loan Programs, which operate on both the state and local levels.[1]

Economic Opportunity Loans

The EOL Program provides long-term loans of up to $25,000 for a maximum of fifteen years to both going and prospective minority entrepreneurs. The loans can be given directly by SBA, in a participation plan with banks or other financial institutions or in a guarantee argeement whereby SBA guarantees 90 percent of the bank's loan.

These loans are directed at low income people who are considered "socially or economically disadvantaged" and who cannot on their own secure any type of long-term credit from the commercial lending institutions with reasonable terms. Every applicant must demonstrate some assurance that he has the ability to run a viable business. He must also have some of his own money to invest, even though the amount is nominal, and SBA needs some assurance that he can repay the loan out of accumulated profits. This is the most flexible of SBA's loan programs, since the key element in evaluating the loan application is the character of the potential borrower, which is measured by the judgment of the loan officer. It is also the smallest with respect to the maximum amount of a single loan.[2]

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[1]U.S. Small Business Administration, SBA What It Is--What It Does (Washington, D.C.: Government Printing Office, 1970), pp. 3-7.

[2]U.S. Department of Commerce, Federal Programs Assisting Minority Enterprise, p. 31.

Operation Business Mainstream Loans

These loans are provided under the authority of Section 7(a) of the Small Business Act. Loans made under Section 7(a) can be accomplished in one of three ways: (1) guaranteed loans, by which SBA may guarantee 90 percent, or $350,000, whichever is less, of a loan made by a commercial bank; (2) participation loans by which SBA may lend up to $150,000 or an immediate participation basis with a commercial lender; and (3) direct loans, by which SBA can provide a single unilateral loan of up to $100,000.

The guarantee plan is the most desirable from the standpoint of SBA since the commercial lender is parting with his own money and is more apt to take a continued interest in his borrower, even with the SBA guarantee. The participation plan is the next most desirable and is used only when the total funding requirement cannot be met by a commercial lender and if an SBA guarantee loan cannot be made. The direct loan plan is the least desirable and will only be considered by SBA upon receipt of substantiation that loan applications to at least two commercial banks have been made and rejected. These loans may be obtained for a maximum of ten years for a straight business loan, similar to a long-term debt instrument to increase financial leverage; fifteen years for construction purposes; and six years for working capital purposes.[1]

The credit requirements for an SBA loan hinge on the same criteria of character, capacity, condition, credit and

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[1]*Ibid.*, p. 35 and U.S. Small Business Administration, *SBA Business Loans* (Washington, D.C.: Government Printing Office, 1971), pp. 1-6.

capital as they would at any lending window, but the measurement of these criteria is obviously more liberal or SBA assistance would not be required. For a minority businessman, an even more liberal approach is taken and, as with EOL assistance, character is considered an extremely important factor.[1] Another important difference is that whereas a normal SBA loan applicant must be able to provide at least one-half of the funds from his own resources if the loan is for a new venture, a minority borrower is required to provide only 15 percent himself. Even this requirement can be lessened or even waived at the discretion of the SBA Regional Director. Collateral for the loan is another criteria that is given less consideration under this program.[2]

To apply for a loan under either of these programs requires that the minority businessman prepare a business package for SBA as he would have to for any commercial loan. For an established business this package consists of:

(1) A current balance sheet and profit and loss statement for the past business year.

(2) A current personal financial statement.

(3) A list of collateral, at estimated present market value, which might be used to secure the loan.

(4) A business plan, which should include pro forma financial statements, sales forecasts and a statement of the amount and purposes for which the loan will be used.

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[1] U.S. Small Business Administration, SBA Business Loans, p. 4.

[2] Ibid., pp. 10-12.

(5) Statements from commercial lending institutions as to whether they will or will not grant a loan independently, and if not, if they will join in an SBA guarantee or participation program.[1]

For a proposed new venture the package consists of:

(1) A detailed description of the proposed business.

(2) A description of the entrepreneur's business and managerial experience and qualifications.

(3) An estimate of the financial backing that can be obtained personally plus a current personal balance sheet.

(4) An earnings projection for the business' first year of operation.

(5) A list of collateral, at estimated present market value, which might be used to secure the loan.

(6) Statements from commercial lending institutions as to whether they will be willing to grant a loan or join with SBA in a guarantee or participation loan.[2]

Local Development Company Loans

The final lending program that will be reviewed is the State or Local Development Company Program, sometimes referred to as the 501 or 502 Programs, respectively, since they derive their legislative authority from those two sections of the Small Business Investment Act.[3] These programs are designed to combine

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[1] *Ibid.*, pp. 13-15.

[2] *Ibid.*, pp. 13-15.

[3] U.S. Small Business Administration, *1962 Annual Report* (Washington, D.C.: Government Printing Office, 1963), p. 34.

the resources of the local community, including its lending institutions, with those of the Federal government to create increased business and job opportunities in economically depressed areas.[1] The most prevalent form of organization is the Local Development Company (LDC).

To qualify for LDC money under this program a group of at least twenty-five local citizens must design a business development plan for their community, quantify it in terms of total investment required, and be able to invest from 10 to 20 percent of this total themselves depending on the population of the community concerned. SBA then can join with the local financial institutions, on either a guaranteed or participation base, to raise the balance of the project's cost. As with a 7(a) guaranteed loan, SBA's limit is 90 percent or $350,000, whichever is less.

The money thus raised can be used for the construction of new plants, or the expansion, modernization or conversion of existing plants including the acquisition of land, buildings, machinery and equipment. The money cannot be used for the purpose of increasing working capital.[2]

The LDC program is not as significant to an independent small minority businessman as the other two direct lending programs since it is designed more for the development of larger

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[1]U.S. Small Business Administration, 502 Local Development Company Program (Washington, D.C.: Government Printing Office, 1968), p. 1.

[2]Ibid.

enterprises with the emphasis being primarily on the creation of greater employment opportunities. However, for the purpose of studying the potential viability of the MESBIC Program, the above brief review of the LDC Program is considered important for two reasons. First, it is a program that can combine the resources of an individual businessman, his community leaders, his local financial institutions and a Federal agency on a coordinated basis to stimulate business development on a larger scale than could be accomplished by a businessman on his own. Secondly, and of even greater importance, is the fact that the direction and control of the project is kept within the community. This facet of the LDC Program is extremely important in the ghetto areas where many other business development plans have failed because the local citizens themselves have not had an opportunity to help determine their own economic destinies.

Evaluation of SBA Loan Programs

From a quantitative standpoint, there has been a significant increase in both the number of loans made by SBA to minority businesses and the total dollar value of these loans. As Table 7 shows, the total percentage of the dollar value of all SBA loans going to minority businesses has increased from 7 percent in 1968 to 19 percent in 1971. The number of minority business loans has increased by 235 percent and the dollar value has quadrupled. The greatest percentage gains have been made in the EOL area, where minority loans now account for slightly over 80 percent of both the total number and dollar volume of such loans.

TABLE 7

SMALL BUSINESS ADMINISTRATION
FINANCIAL ASSISTANCE ACTIVITY - TOTAL - MINORITY ENTERPRISE
(Dollars in Millions)

FY	Loan Program	Total Loans Approved No.	Total Loans Approved Amt.	Minority Loans Approved No.	Minority Loans Approved Amt.	Percentage ME to Total No.	Percentage ME to Total Amt.
1968	7A	9,460	$ 496.2	874	$ 21.7	9%	4%
	EOL	2,899	31.4	1,365	14.6	47	46
	DBL	327	44.8	29	1.3	9	3
	DCL	414	51.9	67	3.7	16	7
		13,100	$ 624.3	2,335	$ 41.3	18%	7%
1969	7A	9,483	$ 547.9	1,460	$ 58.3	15%	11%
	EOL	4,244	51.2	3,118	38.2	73	75
	DBL	283	33.5	20	1.3	7	4
	DCL	513	66.7	56	6.8	11	10
		14,523	$ 699.3	4,654	$104.6	32%	15%
1970	7A	8,719	$ 528.3	1,629	$ 84.4	19%	16%
	EOL	5,539	72.6	4,505	60.6	81	83
	DBL	338	41.5	23	2.9	7	7
	DCL	506	67.1	105	12.5	21	19
		15,102	$ 709.6	6,262	$160.4	41%	23%
1971	7A	13,754	$ 923.9	2,123	$121.5	15%	13%
	EOL	6,789	92.8	5,451	75.7	80	82
	DBL	386	40.9	31	1.6	8	4
	DCL	452	60.9	171	14.9	38	24
	For. Trade	4	4.0	-	-	-	-
		21,494	$1,122.1	7,776	$213.8	36.1%	19%

Source: Small Business Administration

A significant increase in the size of each loan has also occurred. In 1968, the average (median) size of an individual 7(a) loan was $25,000. This figure has increased to over $57,000 in 1972. Under the EOL program, which has a maximum limit of $25,000 per loan, the average size of an individual loan has increased from $10,700 to $14,000 in this same four year period. Although averages taken by themselves can be misleading, the trend toward larger individual loans may indicate that minority businesses are getting larger. This, in turn, may mean a trend away from the more marginal "Mom and Pop" type businesses which have a much higher propensity of failing.

There is another trend developing the SBA loan program, however, which has disturbed officials of the Agency's Office of Minority Enterprise (OME). Table 7 does show a continued increase in both the total number and total dollar value of approved minority loans. On a percentage basis, however, it also shows what may be a trend of de-emphasis in these loan programs. In 1970, 23 percent of the dollar value of all loans were made to minority businessmen, but in 1971 this amount had decreased to 19 percent. Through the first four months of fiscal year 1972, this figure is running at only 17 percent.[1] SBA officials interviewed by this writer did not wish to offer additional information or personal opinions regarding this trend. However, by piecing together information derived from each interview, the following may prove to be some of the reasons why this

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[1]Richard Robinson, private interview at U.S. Small Business Administration, Washington, D. C., October, 1971.

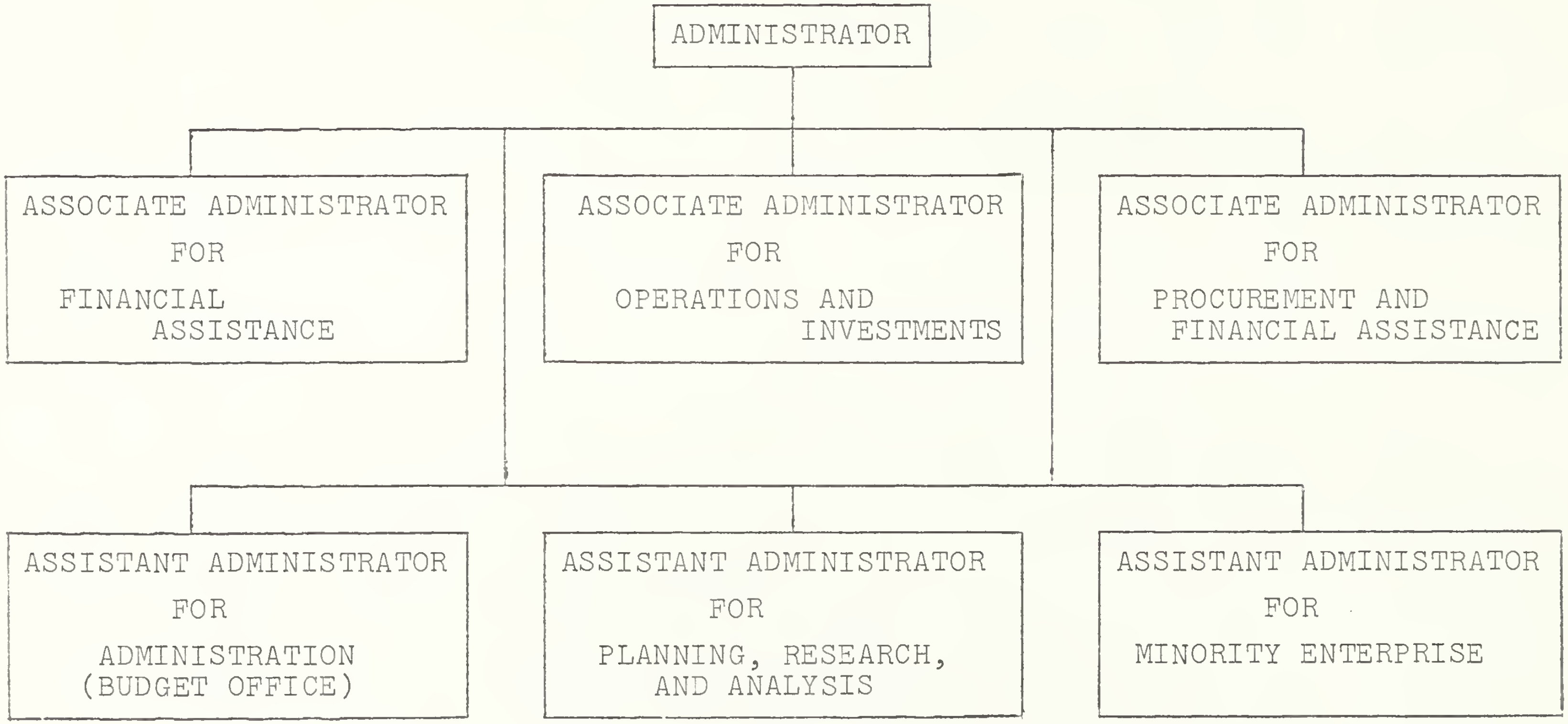
decrease in the relative percentage of loans to minority businesses may be occurring.

One reason may be due to the organizational structure of SBA itself. As Table 8 shows, the Associate Administrator for Minority Enterprise is on a lower rung of the organizational ladder and his Office operates in a staff capacity along with the Office of Administration and the Office of Planning, Research and Analysis. Although this Office is the Agency's chief advocate for minority enterprise, its administrator is an advocate without financial portfolio. The office which has both policy and budgeting authority for all direct lending programs, for both small businesses and minority businesses, is the Office for Financial Assistance. One official of this Office did state that forecasts of earlier years had predicted that the minority lending program would peak out by 1971, when it was thought that commercial lending institutions would be carrying the major share of the lending activities to minority businesses.

Another reason for this trend may be simply a matter of workload. Since minority businessmen were expected not to be as proficient in developing the loan paperwork package as the normal small businessman, SBA created the position of Minority Enterprise Representative (MER) in 1968, and assigned a total of 100 of these minority specialists to its branch offices in 44 cities. These MERs were drawn primarily from SBA jobs they had held in the financial and management areas and 80 percent of them are of minority races. The objective of this move was first to

TABLE 8

SMALL BUSINESS ADMINISTRATION
MODIFIED ORGANIZATION CHART FOR BUDGET DEVELOPMENT



Source: R. Robinson, Office of Minority Enterprise, U.S. Small Business Administration, October, 1971.

establish a better rapport between the potential lendee and the first SBA representative with which he would come in contact. Secondly, the MER would be able to give the loan applicant more assistance in working with the loan package than was normally provided.[1]

The MER concept worked well until the loan business made its gigantic growth in fiscal year 1969. As Table 7 shows, the original 100 MERs, who processed 2,335 loans in fiscal year 1968, were required to process 7,776 loans in fiscal year 1971. Since most minority loan processing takes a great deal more time than normal loans, due primarily to the extra services provided by the MER, a point of diminishing returns had to be reached sooner or later. The Agency has attempted to obtain additional ceiling points to respond to this increased workload, but the Office of Management and Budget (OMB) has kept a freeze on all new Federal hiring for the last couple of years and no new MERs have been obtained.[2] No relief appears to be in sight either, since OMB's Budget Circular A-11 for fiscal year 1973, clearly states that "personnel currently authorized will be utilized to the maximum extent in staffing new programs and

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[1]U.S., Congress, Senate, Select Committee on Small Business, statement before that Committee by Thomas S. Kleepe, pp. 3-6.

[2]Harry Carver, private interview at U.S. Small Business Administration, Washington, D.C., October, 1971.

expansions in existing programs, and a reduced number of personnel should generally be planned where the workload is stable."[1]

A final reason for this trend may be due to the increased loss rates on minority loans over the past five years which may be causing some SBA officials as well as the banking community to take a harder look at the liberal lending policies. SBA charge-offs have been increasing substantially from a low of 3.5 percent in 1966, to a high of 21 percent in 1970. Some increase was to be expected due to the rapid expansion of the program, but the trend in losses seems to be growing at a compound rate. A few observers feel that one of the reasons for such an increase in losses is that the early loans were more apt to go to minority businessmen who were already established in business and had a higher probability of remaining successful. As the program has grown it has become increasingly more difficult to find applicants as potentially capable of succeeding.[2]

This loss experience has not been considered unusual, since a 1971 study of major Eastern bankers revealed an 18 percent charge-off rate and a 9 percent delinquency rate. Most of these loans were to retail concerns. A principal reason given by these banks for the high loss and delinquency rates was the fact that the banks themselves did not follow up on the business progress of their lendees because the size of the loans

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[1]U.S. Office of Management and Budget, Preparation and Submission of Annual Budget Requests, Circular A-11 (Washington, D.C.: Executive Office of the President, June 21, 1971), Sec. 13.2, p. 10.

[2]"Financing Minority Businesses," p. 13.

were so small, averaging $13,000 per loan. Chase Manhattan indicated that its initial loss experience in minority business loans was 15 times higher than its normal rate. Lack of entrepreneural knowledge on the part of the lendee and lack of experience on the part of the bank in knowing how to properly assist this class of lendees were cited as the two major reasons for this high initial loss rate, which bank officials fully expect to lessen in the future.[1]

In summary, then, it can be seen from this brief review of the SBA's history and programs that much greater attention has been given to the financial needs of minority businessmen in the last three years. But while the lending programs are important, they do not provide the same degree of permanency to the financial structure of a minority business as does a more permanent type of equity capital. It was for this reason that the Small Business Investment Company (SBIC) program was looked to in 1969 as a possible model for providing this equity capital to minority businesses.

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[1] Ibid., pp. 13-14.

CHAPTER V

THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM

Introduction

The purpose of this chapter is first to discuss the legislative history and provisions of the Small Business Investment Act, since it governs both the Small Business Investment Company (SBIC) and the Minority Enterprise Small Business Investment Company (MESBIC) programs. Next a review of the highlights of the SBIC industry's tempestuous history will be made since it was functioning for eleven years before the MESBIC program was launched. The purpose is to see what operational pitfalls have been encountered in the development of this industry. This will allow us to see whether they are being avoided in the MESBIC program. Finally an analysis of the performance of the SBIC industry will be given with respect to satisfying the equity needs of the small business community.

The Small Business Investment Act

Since World War II, there has been growing concern over the future of the small businessman in our country. Much of the debate has centered around whether small businesses are able to obtain adequate financing to keep them somewhat comeptitive in this era of the corporate giants. Between 1949 and 1958, various Senate and House Committees studied many proposals

designed to provide more Federal financial assistance to small businessmen. The Small Business Administration, with its loan and management programs was created as one means of assisting small businessmen. But there seemed to be something still missing in the total financial machinery. This missing element was a ready source for small businessmen to obtain financial assistance of a more permanent nature, e.g., equity or long-term capital.

During 1957, the House Small Business Committee and the Senate Banking and Currency Committee continued to hold hearings on small business problems. The testimonies varied from that of Mr. Maxwell of the American Bankers Association who felt that the normal lending institutions provided adequate financing, to that of Dr. A. D. H. Kaplan of The Brookings Institution who believed that a device such as the National Investment Act was needed to assist small businessmen. He felt that small businessmen were not equipped to obtain adequate financing on their own.[1]

It was not, however, until the Federal Reserve Board issued a report entitled Financing Small Business to the Congress, in April of 1958, that a comprehensive analysis of the financial viability of the small business community was better understood. In summary, the report indicated that the small businessman received a smaller percentage of the total loans issued by member

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[1] U.S., Congress, House, Select Committee on Small Business, Credit Needs of Small Business, Hearings, before Select Committee on Small Business, 85th Cong., 1st sess., 1957, pp. 129-132, 212.

banks in the period 1955 to 1957 than larger businesses, based on the relative numbers of businesses in each sector. Further, the average size of the loan for businesses with assets of less than $5 million had decreased. Smaller companies also faired less well in obtaining long-term loans than did larger firms.

Although the overall net findings did not provide conclusive evidence that small businesses were being financially discriminated against to any sizeable degree, the report did conclude that sources of financing were not adequate to the apparent needs of small businessmen, primarily in terms of long-term credit.[1] This report, along with the preponderance of Congressional testimony that favored increased Federal assistance, paved the way for passage of the Small Business Investment Act of 1958.

In passing this Act, the Congress declared that:

> The policy of the Congress and the purpose of this Act (is) to improve and stimulate the national economy in general and the small-business segment thereof in particular by establishing a program to stimulate and supplement the flow of private equity capital and long-term loan funds which small-business concerns need for the sound financing of their business operations . . . and which are not available in adequate supply . . . this policy shall be carried out in such manner as to insure the maximum participation of private financing sources.[2]

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[1]U.S. Federal Reserve System, Financing Small Business, Report to Committee on Banking and Currency and the Select Committee on Small Business by Federal Reserve System, Parts 1 and 2, 85th Cong., 2nd sess., April 11, 1958, pp. 122-125.

[2]U.S., Congress, Senate, Select Committee on Small Business, Small Business Investment Act of 1958, as amended by Pub. L. 92-213, 92nd Cong., 1st sess., S.J. 176, Dec. 22, 1971, sec. 102.

In carrying out this declaration, the Act was designed primarily to stimulate the private sector to create investment companies that would be geared solely to the equity and long-term financial requirements of the small business community.

The privately-owned investment institutions so created under this Act are called Small Business Investment Companies (SBIC). As such, an SBIC is conceived by the Act as a permanent profit-making institution. The prime incentives to stimulate the formation of SBICs are low-cost Federal financial leverage support and tax incentives in the event of failure. The ultimate objective of the Act was to help close the financial capital gap facing small businessmen through federally supported but privately managed financial institutions.[1] The Act established the Small Business Investment Division in SBA and charged it with Federal administrative responsibilities of licensing and regulating the SBIC industry.[2]

The minimum financial requirement to qualify for a SBIC license is $150,000 of private paid-in capital and paid-in surplus. A national bank is eligible to purchase shares in a SBIC, but is restricted to investing no more than 5 percent of its capital surplus. Further, a bank may not own 50 percent or more of any class of a SBIC's equity securities and cannot

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[1]U.S. Small Business Administration, Starting a Small Business Investment Company (Washington, D.C.: Government Printing Office, 1969), pp. 1-5.

[2]Small Business Investment Act., sec. 201.

possess voting rights.[1] Some SBIC's are owned by small groups of local investors, some are organized as subsidiaries of national business concerns and others are publicly traded. With respect to the individual owners, the SBA has strict regulations to ensure that SBIC's are not formed as holding companies for the purpose of obtaining Federal lending for an owner's other business ventures and that potential conflict of interest issues are avoided.[2]

With respect to borrowing power, the Act does allow a SBIC to obtain long-term funds from SBA, which is probably the key incentive to the concept. The SBA may either purchase or guarantee the purchase of an SBIC's debentures up to 200 percent of the combined paid-in capital and paid-in surplus of the company, with a maximum limit of $7.5 million. In addition, if an SBIC has paid-in capital and surplus of at least $1 million, and has 65 percent of its total funds available for investment either invested or firmly committed in venture capital investments, the SBA can either purchase or guarantee the purchase of $2 million in debentures plus 300 percent of the paid-in capital and surplus which exceeds $1.0 million. The maximum amount that SBA can either purchase or guarantee in this situation is $10.0 million.

In addition to the words "or guarantee" with respect to the SBA's ability to purchase a SBIC's debentures is the most

[1]*Ibid.*, sec. 302.

[2]U.S. Small Business Administration, *SBA Rules and Regulations Part 107, as amended* 36 F.R. 18858 (Washington, D.C.: Government Printing Office, 1971), sec. 107.901 and 107.1004.

recent amendment to the Act. This guarantee proviso now gives the SBA increased flexibility to underwrite a private lending institutions's loan to a SBIC, similar to the underwriting of a bank's direct loan to a minority business.[1]

The debentures sold to or guaranteed by SBA may be subordinated and may have a term of up to 15 years.[2] Since the prime emphasis of the program is on venture capital, the maximum leverage factors above provide the greatest incentive for SBIC's to structure their investment portfolios in that direction. One important stipulation of the Act is that federal funds will be provided to a SBIC ". . . only to the extent that the necessary funds are not available to (the SBIC) from private sources on reasonable terms."[3] The SBA makes the final determination as to the reasonableness of the terms.

A SBIC can invest in a small business concern primarily by buying its equity securities or by making it a long-term loan. For purposes of the Act, both forms are considered venture capital financing.[4] The word primarily is used because a SBIC can make short-term loans to a small business concern with which it already has invested long-term money, but only when it is considered in the interests of protecting the SBIC's primary investment.[5]

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[1]Small Business Investment Act., sec. 303(b).

[2]Starting a Small Business Investment Company, p. 14.

[3]Small Business Investment Act., sec. 303(b).

[4]SBA Rules and Regulations, sec. 107.3.

[5]Ibid., sec. 107.504.

The primary emphasis again is on equity financing and the hope is, of course, that as the small business grows and prospers so will the SBIC's investment in the form of capital gains. To ensure that there is a reasonable degree of permanency in the investment, the SBIC must hold the initial security for at least five years with repayment not due until this earliest "maturity" date. The equity securities may be in the form of any class of stock and may include convertible, warrant and option provisions.[1]

Long-term loans may be issued as such or with warrants enabling the SBIC to purchase stock in the company during a period of time not to exceed ten years. Convertible debentures may also be issued. The interest rates for these instruments are subject to negotiation between the SBIC and its client, but are subject to the regulations of the governing state and may not exceed 15 percent in any case. Loans and debentures must be issued for a minimum of five years and voluntary amortization during the first five years cannot exceed 20 percent of the principal per year.[2] The Act specifies a maximum lending period of twenty years, with a ten year extension if the SBIC believes that the additional time for liquidation will be in its own best interest.[3]

There is a limitation on the amount of financing a SBIC can make to any one company and the amount of control it can have

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[1] _Ibid._, sec. 107.302.

[2] _Ibid._, sec. 107.301.

[3] _Small Business Investment Act_, sec. 305(d) and (f).

in a company. Without the express approval of the SBA, A SBIC cannot invest more than 20 percent of its combined paid-in capital and paid-in surplus in any one company.[1] Except in rare instances, an SBIC or two or more SBICs acting as joint financiers cannot exercise control over a small business concern. Besides the normal 50 percent voting stock rule, SBA defines control as being any situation in which the SBIC owns as much of a voting interest in a small business as any other one block of stock.[2] The only exception made to this rule is when the small business concern and the SBIC have entered into a fairly negotiated plan at the time of financing as a mutual contractual obligation. The plan must be approved by SBA and cannot extend beyond seven years.[3]

With regard to a SBIC's investment portfolio, no more than one-third of the total portfolio may be invested in any one set of business concerns classified together as a major group in the Standard Industrial Classification Manual issued by the Office of Management and Budget.[4] A SBIC cannot lend money to a company for the purpose of relending or reinvesting, for the development of unimproved real estate, for gambling or monopolistic interests or for production of agricultural commodities. In addition, the small business concern can purchase goods or

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[1] Ibid., sec. 306(a).

[2] SBA Rules and Regulations, sec. 107.901 (a) and (b).

[3] Ibid., sec. 107.901 (d).

[4] Ibid., sec. 107.101 (e).

services from a supplier, who in turn is an associate of an owner of that SBIC, only if less than 50 percent or more of the funds borrowed from the SBIC are used.[1]

Besides the incentive of being able to borrow leverage money from the SBA, a SBIC also enjoys a substantial tax advantage over normal investment companies. First an investor in a SBIC can treat losses in the value of his stock as a normal operating loss and not a capital gains loss, which gives him more flexibility in applying this loss. Gains, however, can be treated as capital gains.[2] Second, a SBIC itself can treat losses in its investments as normal operating losses and can deduct 100 percent of the amounts received as dividends on its investment from its earnings for tax purposes.[3] SBICs are also exempt from paying the accumulated earnings surcharge as long as they are actively engaged in providing funds to small business companies in compliance with the Small Business Investment Act.[4] These, then, are the major tax incentives available to the management of a SBIC.

Performance of the SBIC Industry

Since its passage in 1958, six major revisions have been made to the Small Business Investment Act in an attempt to make it a more viable instrument of public policy. Some of the

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[1] Ibid., sec. 107.1001.

[2] U.S., Congress, House, Technical Amendments Act of 1958, Pub. L. 85-866, 85th Cong., 2nd sess., 1958, H.R. 8331, sec. 1242.

[3] Ibid., sec. 1243.

[4] U.S. Treasury, Accumulated Earnings Surtax Exemption, Treasury Decision 6652 to Income Tax Regulations 1.533-1, May 13, 1963.

amendments have been made to cover loopholes and provide more stringent Federal control over the SBIC industry in the wake of some extremely bad publicity received by it. Other amendments have been designed to expand the capabilities of SBICs by providing more Federal funding and greater operating flexibility.[1]

An example of the negative criticism that caused legislative revision is testimony that was given to Congress in 1966 by Elmer B. Staats, the Comptroller General of the United States, when he disclosed that the SBA's financial and accounting records contained inaccurate and incomplete information with respect to the SBIC industry, and especially the status of SBA loans.[2] One of the cases he cited to support his findings concerned the Cascade Capital Corporation, in which he stated that:

> Cascade Capital Corporation of Spokane, Washington, was licensed as an SBIC in April, 1961. Its capital consisted of $191,000 in private funds and $317,000 in SBA money. It also lost money steadily since the beginning of its operations.
>
> The first SBA examination of this SBIC was in April of 1962. At that time, it had a deficit of 30 percent. In September of that year, the deficit reached 51 percent, and by April, 1963 it totaled 96 percent. In spite of this record, SBA advanced a total of $190,000 to Cascade during this deficit period.
>
> The records show little action by SBA during 1963 and 1964 to protect the Government funds other than correspondence to request additional private capital and to ask for a plan to bring the company into profitable operations.
>
> In June 1964, a conference was held between officers of Cascade Capital and SBA representatives, who recommended to Washington that an immediate assignment of the

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[1] Small Business Investment Act, p. iii.

[2] U.S., Congress, Senate, Committee on Government Operations, Investigation into Small Business Investment Company, Hearings before the Permanent subcommittee on Investigations of the Committee on Government Operations, Senate, 89th Cong., 2nd sess., August, 1966, pp. 55-73.

SBIC's assets be obtained to protect the Government. No action was taken until April of 1965 when the SBIC was examined again. Continued financial deterioration was shown. The deficit had grown to 158 percent, completely wiping out the private stockholder's interest.

No action was taken in 1966. SBA officials told GAO that some tentative attempts to merge the SBIC were unsuccessful. No request for a receiver was made, but SBA indicated that it might be done shortly. The deficit had grown to 190 percent at the time of the last report.[1]

On the more positive side, in 1966 applications for SBIC financing reached new highs; SBA evidence showed that small business concerns were making good use of the SBIC funding received, with one study showing that companies receiving SBIC funding had increased profits nearly 400 percent; and for the first time in its history, the SBIC industry reported net profits for the fiscal year ending March 31, 1966.[2]

In testimony before Congress, the SBA's Administrator stated:

> The great bulk of the companies in the industry have the bare minimum of private capital required by statute. The inadequacy of such resources is reflected, intangibly, in poor management skills and, tangibly, in a low return on invested capital. For the year ended March 31, 1966, SBICs in this category (statutory capital and surplus of $325,000 or less) actually suffered a loss of 2.3 percent on their investment.
>
> We undertook a detailed study to determine the size of the SBIC which would stand the best chance of establishing and maintaining a profitable operation. In this study, we attempted to develop a model to meet such requirements. The results of this study indicated to us that at least $1 million of private capital would be necessary to (1) interest prospective investors and competent management; (2) pay competent full-time management;

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[1] _Ibid._, p. 63.

[2] U.S., Congress, Senate, Committee on Banking and Currency, _Small Business Amendments of 1967, Hearings_, before subcommittee on Small Business of the Committee on Banking and Currency, Senate, 90th Cong., 2nd sess., June 1, 1967, p. 59.

> (3) make thorough investigations of investment prospects; (4) maintain continuous service for portfolio concerns including advisory services; (5) insure a competitive return on investment; and (6) create reasonable prospects for success.[1]

While the above testimony may appear at first glance to be self-condemning, it really was meant to set the stage for revisions to make the industry stronger. The revisions that ensued changed the law so that all SBA investments in SBIC would be of the subordinated debenture variety, and not both debentures and straight loans. This tended to give the SBIC a more permanent type equity base by which to utilize commercial leverage. Further, the 1967 revisions increased the maximum amount of SBA participation in a SBIC from $4 million to $7.5 million.[3]

The SBIC industry has had a tempestuous fourteen year history, as can be seen by the data in Table 9. Although there was much interest in the concept to begin with, only 86 companies had been formed by early 1960. Some SBA officials claim that this slow initial growth rate was not well received by the White House and so the Agency conducted a hardsell campaign and licensed anyone who looked even remotely like a possible SBIC candidate. While the truth of this cannot be confirmed, Table 9 does show that a dramatic increase in the number of licenses issued occurred between 1960 and 1962.

Another important factor in this rapid growth pattern was the general stock market boom in the early 1960s and the

[1] *Ibid.*, pp. 29-30.

[2] *Small Business Investment Act*, p. iii.

TABLE 9

SBIC INDUSTRY FINANCIAL DATA
1960 - 1971
(Dollars in Millions)

Date	No. of SBICs	SBICs Reporting	Private Capital	Retained Earnings	Loss Allow.	Total Asset	Net Return on Capital
3/31/60	86	80	$ 39.7	-	$ 4.1	$ 43.3	.04%
3/31/61	204	200	174.6	-	1.4	195.5	(.08)
3/31/62	533	516	436.3	(2.5)	6.8	508.9	(.7)
3/31/63	678	615	460.0	(14.0)	20.6	599.2	(1.8)
3/31/64	723	649	463.7	(35.6)	39.4	657.2	(4.0)
3/31/65	713	645	459.9	(47.6)	54.0	699.7	(3.5)
3/31/66	700	606	433.8	(36.2)	47.6	710.2	2.5
3/31/67	669	548	393.2	(21.4)	42.0	691.5	2.4
3/31/68	542	441	342.6	4.0	35.5	637.5	6.0
3/31/69	487	373	325.0	25.1	33.6	630.1	9.5
3/31/70	451	331	332.1	17.8	33.8	633.3	3.1
3/31/71	442	288	324.9	(4.4)	44.0	611.9	(3.6)

Source: Small Business Administration and SBIC Industry Review, December 1971.

emergence of the small technologically-oriented "hot issue" growth companies. Both of these factors further stimulated the fast rise of public SBICs, which itself was considered a potential high flyer. The SBICs themselves appeared to invest heavily in these new growth companies, which completed the self-fulfilling prophecy that as long as one link in the chain remained healthy all would remain healthy.[1]

The dawning of recognition that this prophecy cut in both directions finally came in May of 1962, when the market collapsed. The index on SBICs fell from 23 in 1961 to 7.7 in May of 1962.

A typical example is the case of the Greater Washington Industrial Investments Company, a SBIC that financed a computer and systems analysis company whose stock rose in market value from 8 to 90. Greater Washington's stock, riding on the success of this investment, rose in value from 8 1/2 in 1960 to 31 1/2 in 1961. When the computer company's stock fell in 1962, Greater Washington's stock dropped to 6 5/8.[2]

Whether for better or for worse, the events of 1962 pretty well closed the door to the continued formation of the publicly-owned type of SBIC. The learning curve appeared to be long and hard for both Congress and the SBA, as the early annual revisions to the initial legislation shows. The lesson to be learned was that a SBIC could be as harmful to small businesses as it was supposed to be helpful. By supplying

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[1]"The SBIC's Road Back," Fortune, LXXIV (August, 1966), 194.

[2]Ibid., p. 196.

financing to these precariously founded long-shot ventures, which might have been refused financial support from a wiser and more mature financial institution, the SBIC could help to aggravate any instability already present in the market. More seriously, the SBIC could do this with the taxpayer's money.

By 1966, the SBIC industry appears to have reached its maxima, in terms of the number of SBICs and the total financial strength of the industry. As Table 9 shows, 700 SBICs were licensed with a combined total assets of $710.2 million as of March 31, 1966. This was also the first year that the industry made a profit, but it was not until 1968 that the combined retained earnings figure finally went into the black. Although the figures in Table 9 look good, they do not tell the full story.

Between October 1964 and April 1966, SBA considered that the number of problem SBICs increased from 129 with $35 million in SBA funds outstanding to 232 with $67 million. The Agency expected to lose about $18 million on investments in 103 SBICs totaling $37 million.[1] In a speech to SBIC managers in June of 1966, Richard E. Kelley, associate administrator of the SBA's investment division, confirmed that about one-third of all SBICs were problem companies. Fifty-five of them had lost at least half of their private capital, seventy were either under investigation or being sued by the SBA, sixty were either

[1] U.S., Congress, Senate, Committee on Banking and Currency, The Small Business Investment Program, Hearings before a subcommittee of the Senate Committee on Banking and Currency, 89th Cong., 2nd sess., July, 1966.

inactive or about to give up their licenses, and forty-seven had seriously violated SBA regulations. Kelley's speech made quite a stir in the financial world, but as the editors of Fortune pointed out, he failed to properly qualify his condemnations. Kelley later explained to Fortune that actually the problem companies were almost all small, privately held SBICs and that three-quarters of them were one-man operations.[1]

This then gave recognition to the second big object lesson to the industry. A small, marginal SBIC trying to help small, marginal businesses only compounds the probability of failure by both ventures. From this point on, the SBA began to plot the track record of the SBIC industry by looking at four separate financial classifications: those with total paid-in capital of up to $300,000 in size I, those between $300,001 and $1 million in size II, those between $1,000,001 and $5 million in size III, and those above $5 million in size IV. As will be shown later, there has been a marked difference in the performance of the different size groupings, but not always as SBA has thought would occur.

One example of the change of investment policy and philosophy many SBICs were forced to take, as a result of the May 1962 fiasco, is described by the experience of the Electronics Capital Corporation (ECC) of San Diego. This SBIC company rode the boom of 1960 and 1961 when its stock zoomed from $10 per share to $70 nearly overnight. In May, 1962, the price

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[1] "The SBIC's Road Back," 194.

fell to $6 per share and ECC's chairman Charles E. Salik had to change the rules of his game.

ECC was formed in 1959 to provide venture financing to new electronic companies. Besides funding, ECC also was able to provide its clients management consulting services, a research laboratory and a central sales organization. Of the first seven ventures, three succeeded, two merged and two failed. After the market fell in 1962, ECC was hurt badly and was not able to become really investment active again until 1965. But when ECC did begin looking for investments, new ventures were totally ruled out. Salik wanted only solid businesses with proven records and annual sales of approximately $8 million. Only under those conditions did he feel that the risk was worth the gamble. As a result of ECC's new investment policy, it became the largest SBIC in 1967 with assets of $26 million and a steady but growing earnings pattern.[1]

While this experience of ECC makes interesting reading as a "success" study of a struggling SBIC, the success is only in the eyes of the beholder -- Charles Salik. For the purposes of the small business community, ECC became just another closed financial window to it. With a no new venture and sales of $8 million investment policy, both sound criteria for a normal investment company to follow in order to avoid the disaster once faced by ECC, the company could barely be called a SBIC in

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[1] "Thinking Big About Small Business," Business Week, January 7, 1967, pp. 123-125.

terms of the original concept. As a matter of fact, ECC has since surrendered its license to SBA.

From 1966 to 1971, the SBIC industry became profitable but the total number of SBIC's has decreased from 700 in 1966 to 442 in 1971. Much of this decrease was planned by SBA, and was forecasted earlier by SBA Administrator Boutin, who had stated in 1963:

> I would forecast that within the next twelve months . . . we will have this program down to 350 companies. Some will go by merger, some by voluntary surrender of their licenses, some by court action, and some by administrative action by SBA.[1]

It was under his tenure that the 1967 amendment was passed which incentivized the formation of larger and more stable SBICs. This lack of incentive for the larger SBIC was probably one of the other reasons ECC left the SBIC business. Greater Washington Investors, another of the large SBICs, also left in 1967 and cited as one of the reasons the lack of flexibility that caused it to reorganize and establish a wholly-owned SBIC subsidiary so that the parent company could continue on its own, yet still have a subsidiary that was smaller and more in line with the prevailing SBIC philosophy.[2]

As Table 9 shows, the years 1967 to 1970 were profitable ones for the SBIC industry, but no conclusive evidence has been given as to why this has been so. That the industry finally

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[1]"SBICs: Rocky Road Looms Ahead," Business Week, July 20, 1963, p. 65.

[2]U.S. Securities and Exchange Commission, Exemptions from Investment Act of 1940 Hearings, before the Securities and Exchange Commission, May, 1969.

began to develop some maturity in its operations is probably one reason. But what affect can be attributed to the overall growth pattern of our economy and the prolonged war effort in Vietnam cannot really be known or measured. Whether SBICs would have fared as well in a different economic climate is hard to say, but the fact that the industry lost money in 1971 might well be a leading indicator of future viability.

A. H. Singer, the SBA's current associate administrator for operations and investments, in his forward to the 1971 annual SBIC Industry Review, stated that:

> The SBIC industry's financial results are highly sensitive to the cyclical nature of the economic and financial systems . . . the data . . . must be evaluated in light of the generally unfavorable economic conditions which prevailed during the period.[1]

This statement was given in partial justification of the industry's 6.7 percent decrease in rate of return from a positive 3.1 percent in 1970 to a negative 3.6 percent in 1971.

As the figures in Table 10 show, it was the largest SBICs that sustained the heaviest losses in 1971 and they also made the fewest number of disbursements.

The disbursement mix for this same period is shown in Table 11.

As Table 11 shows, the smallest SBICs continue to be invested heavily in loan financing while the larger SBICs have a more diversified portfolio. What cannot be reconciled is why

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[1]U.S. Small Business Administration, SBIC Industry Review (Washington, D.C.: Small Business Administration, December, 1971), forward.

TABLE 10

SBIC RATES OF RETURN (ROR) AND DISBURSEMENTS
FOR YEAR ENDING MARCH 31, 1971

SBIC Capital Size	ROR 1970	ROR 1971	Disbursements Number	1971 Amount (000)
I ($300,000 or less)	1.4%	(0.2%)	426	$ 9.6
II ($300,001 to $1 million)	3.1	(1.7)	972	35.5
III ($1,000,001 to $5 million)	5.0	1.8	768	56.6
IV (over $5 million)	2.0	(9.1)	370	54.3
Totals:			2,536	$156.0

Source: Small Business Administration, SBIC Industry Review, pp. 1-2.

TABLE 11

SBIC DISBURSEMENT MIX FOR 1971

SBIC Capital Size	Loans	Debentures	Capital Stock
I	75.0%	18.8%	6.2%
II	57.7	20.3	22.0
III	37.6	32.7	29.7
IV	32.1	33.1	34.8
All Sizes (weighted)	42.5%	29.2%	28.3%

Source: Small Business Administration, SBIC Industry Review, p. 3.

the size IV SBICs fared so poorly as compared to the size III, which disbursed more money during this period and had nearly the same portfolio balance as the larger size. More significant, though, is the fact that only 57.5 percent of all investments made during the year were of a more permanent equity type.

One disturbing trend has been the marked rise in allowances for losses over the past four years. In 1968 the allowance was $35.6 million, or a little over 5 percent of total assets. These figures were held nearly constant in 1969 and 1970, but in 1971 the allowance was raised to $44 million, or approximately 7.2 percent of total assets. This accounted for a $9 million, or 2.8 percent, decrease in net worth during this last year.[1]

Effectiveness of the SBIC Program

In gross totals, the SBIC has 8455 investments outstanding as of March 31, 1971, for a total value of over $472 million. Of these totals, 4033 investments valued at a total of over $281 million were in debt securities and capital stock.[2] It is estimated that since 1958, the industry has made over 37,000 investments providing $1.8 billion in financing to the small business community. The SBA had provided $447 million to finance these SBIC activities from its revolving capital fund.[3]

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[1] Ibid., p. 8.

[2] Ibid., Appendix 2, p. 3.

[3] U.S. Small Business Administration, Budget Estimate -- Fiscal Year 1972, sec. S and E, (undated), p. 40. (mimeographed)

While these figures appear impressive they do not go to the heart of the issue by asking whether the SBIC program has really been effective. The true test is to see what real affect the program has had on the small businesses who have been served by the SBIC industry. There is a paucity of available data in this area, but a SBA study of 1,381 firms who received SBIC assistance leads one to conclude that at face value the data does indicate that the companies have benefited. The study marked the period from March 1967, before SBIC assistance, to December 1968, after SBIC assistance. It revealed:

(1) Employment rose by 29 percent with 1,800 new jobs created.

(2) An average increase of 42 percent in gross revenues was achieved.

(3) Profits more than doubled from $11.1 million to $22.2 million.

(4) Net worth increased 18.8 percent from $179 million to $213 million.

(5) Total assets increased 36.8 percent from $711 million to $975 million.

(6) SBIC assistance increased the ability to obtain an increase of 22.2 percent in short-term borrowings from commercial sources from $113.4 million to $138.6 million.[1]

A recent survey conducted by SBA, using sampling techniques approved by OMB, attempted to assess the value of SBIC assistance in less quantified terms. The survey posed a list of questions to the small businesses selected. The most important questions and their responses were as follows:

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[1]U.S. Congress, House, Select Committee on Small Business, Organization and Operation of the Small Business Administration, Report, H. Res. 53, House, 90th Cong., 2nd sess., 1968, p. 43.

(1) Why did you seek SBIC financing:
63.8 percent either could not get financing elsewhere or could not get reasonable terms.

(2) Why were you refused financing elsewhere:
89.8 percent cited either unsuitable terms, their venture was too risky or their requests exceeded lending limits.

(3) What was the purpose of the loan:
33.8 percent needed additional financing and 31.8 percent needed start-up capital.

(4) Did your business benefit by SBIC financing:
95.5 percent answered yes and 55.5 percent of these indicated the benefit was considerable.

(5) Were you satisfied with your dealings with the SBIC:
85 percent said yes and of the 15 percent who said no, 39.1 percent stated that their inability to get all the money they felt they needed from the SBIC was the main reason.

(6) What, in your opinion, is the type of assistance most needed by small businessmen:
This was an open-ended question and a variety of responses were received. However, 60 percent indicated financial assistance and 27 percent said managerial assistance. (A respondent could have cited both reasons and the responses were included in both figures.)[1]

In analyzing the results of both of these surveys it must be kept in mind that the respondents were businessmen who had actually received SBIC assistance. Therefore, the results are undoubtedly biased somewhat in favor of the SBIC industry. Unfortunately, what is not available is comparative data of those small businesses who were denied SBIC assistance. What is not known is how successful and prosperous they have or have not become during the same time periods. It is possible that some of these businesses who were denied assistance are really the ones for whom the Small Business Investment Act was written.

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[1]U.S. Small Business Administration, Small Business Investment Company Digest, LXXVI - V (September-October, 1971), 3-7.

However, this type of information is not known and one can only keep these questions in mind to qualify the data that is available and keep it in perspective. The data available so far does lead to the conclusion that in general those few who have received SBIC assistance have tended to prosper and that the recipients confirm this belief.

CHAPTER VI

THE MINORITY ENTERPRISE SMALL BUSINESS INVESTMENT COMPANY PROGRAM

The Beginning of MESBIC

In a 1968 campaign speech, later called the "Bridges of Human Dignity" address, then presidential candidate Richard Nixon made a verbal commitment to the cause of minority business development. He stated his position by saying:

> What we need is to get private enterprise into the ghetto, and put the people of the ghetto into private enterprise--not only as workers but as managers and owners. Then they will have the freedom of choice they do not have today; then the economic iron curtain which surrounds the black ghettos of the country will finally be breached.[1]

Although the speech made no mention of any specific program, it set the stage for the creation of the Office of Minority Business Enterprise. From this office came the announcement, in November of 1969, that the Commerce Department and the Small Business Administration were going to co-sponsor a new program (MESBIC) to provide equity capital to the minority business community. A greater "piece of the action" became the slogan of Project Enterprise, and Commerce Secretary Stans set a goal of licensing one hundred MESBICs with a potential to create

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[1]As quoted in Minority Enterprise and Expanded Ownership: Blueprint for the 70's, p. 6.

$225 million in new capital for minority enterprise by June of 1970.[1]

At this point two questions must be raised. The first seeks to answer why the SBIC concept was used for the minority program. The second asks why a different type of SBIC was needed if in fact this type of financial program was considered proper.

The answer to the first question is rather straightforward. As was pointed out in the last chapter, the era 1966 to 1969 was a prosperous one for the SBIC industry, with profits reaching an all time high of 9.5 percent. Optimism was strong for the continued viability of the industry. Also the Government knew that something more than the existing SBA loan programs was needed, but it had little real experience in dealing with the minority business community. Since a reasonably viable small business equity funding industry was already in existence, it seemed logical to use it as a model for assisting the minority businessmen.

The answer to the second question has a political as well as an economic rationale. From the political standpoint, the new Republican administration had made a strong verbal commitment during the campaign and needed a visible and Republican-invented program to give proof to its promise. A new program, aimed and titled specifically at the minority population was probably hoped to given them this proof. From an economic standpoint, the SBIC industry, *per se*, was not geared at that time to the needs of

[1]Rocco C. Siciliano, "A Piece of the Action," *Nation's Business*, LVII (March, 1970), 58.

the minority businessman. SBA rules governing SBIC operations were considered to be too restrictive for proper assistance to minority businessmen and there was a natural fear of over-liberalizing the whole industry. Another element that was desired in the MESBIC program was the strong sponsor concept and a greater emphasis on managerial assistance to the investment company clientele. Finally, it was considered mandatory that a MESBIC be located as close to its potential customers as possible, since it was to be an integral part of the community. This would make the MESBIC both visible and readily accessible to the people it served and also help overcome an inherent distrust of anything with a Federal label.[1]

The first real MESBIC was actually licensed as a SBIC over a year before the program was formally announced. On August 13, 1968, the SBA issued a license to the Arcata Investment Company of Menlo Park, California. Arcata Investment was created as a wholly-owned subsidiary of the Arcata National Corporation, a company primarily in the redwood lumber business but also involved in printing and data handling activities. The idea of creating an investment company dedicated solely to assisting in the development of minority-owned business was fostered by Arcata National's president, Robert Dehlendorf II. He had become greatly disturbed at the racial crisis developing in our country during 1967, and especially the assassination of Martin Luther King. He felt that big business had a public

[1]"Minority Businesses Gain With U.S. Help," Commerce Today, I (January 11, 1971), 12-14.

responsibility to assist in the urban-racial crisis and believed the Arcata Investment might be one way to put his feelings into action.

Arcata Investment was capitalized at $150,000 from the parent company and received a separate budget for salaries and administrative costs. Dehlendorf hired Derek (Pete) Hanson, a Stanford MBA graduate to direct the company and pledged the parent company to contribute 2 percent of its after-tax profits to Arcata Investment for its first five years of operations. Arcata Investment received an SBIC license from the SBA and even under the SBIC rules it managed to help finance more than 35 black-owned or black-oriented businesses during its first 18 months of operations. Arcata Investment gave a total of nearly $500,000 to these businesses which, when combined with the owners private investments of $400,000, enabled these businesses to receive another $1 million in financing from banks and other lenders.[1]

Arcata Investment has not been totally as successful as the above figures would imply, but it has assisted many minority businesses to become more viable. One key to Arcata Investment's success has been the philosophy by which it is managed. As Dehlendorf has said:

> Arcata Investment functions as does the management of its parent company every day of the week. It puts dollars behind the right man, with the right product or service, to meet a market need. It is not 'do-gooding' in the true sense of the word, nor is it attempting to

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[1]"The MESBICs Are Coming -- But Slowly," Black Enterprise, I (September, 1970), 27.

> fill the role of the social worker or the educator, functions to which most corporations are ill-suited.
> In reviewing proposals, the stress has been on community economic need and increased employment in profit-oriented businesses, both within and outside the local disadvantaged community. What we call 'one man band' or 'fat cat' oriented proposals are screened out.[1]

Arcata Investment, then, became the model by which SBA and OMBE patterned the new MESBIC industry. Pete Hanson, the first director of Arcata Investment, has since become OMBE's MESBIC program director.

The remaining portion of this chapter will be devoted first to looking at the legislative and operational characteristics of the MESBIC which differentiates it from a SBIC. Next the brief history of the program will be plotted. Finally, the effectiveness and criticisms of the program as currently voiced will be presented.

Legislation and Structure of the MESBIC

A MESBIC, like a SBIC, is governed by the rules of the Small Business Investment Act. However, the SBA, by the regulatory powers granted to it by this Act, has made changes in its SBA Rules and Regulations governing the SBIC industry to tailor the MESBIC program to the needs of minority businessmen.

The first amendment to these SBA Rules and Regulations which affects minority businessmen was made in early 1969, before the MESBIC program was formally announced. This change allowed all SBICs to provide short-term financing of less than

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[1] *Ibid.*, p. 30.

five years to any persons ". . . whose participation in the free enterprise system is hampered because of social and economic disadvantages."[1]

The purpose of this amendment was to give SBICs a little freedom and encouragement to expand their portfolios to include lendings to minority businessmen. But the actual response of the SBIC industry to minority businessmen has been very weak. Of the industry's total disbursements of $156 million in 1971, only $5.4 million, or 3.5 percent, were made to persons classified by the SBA as disadvantaged.[2]

The second major amendment to SBA Rules and Regulations, with respect to minority businessmen, was made in July of 1970. In this change, MESBICs were formally defined as a:

> License company licensed solely for the purpose of providing assistance which will contribute to a well-balanced national economy by facilitating the acquisition or maintenance of ownership of small business concerns by individuals whose participation in the free enterprise system is hampered because of social or economic disadvantages.[3]

In addition to defining a MESBIC, this amendment also authorized regular SBICs to operate MESBICs as wholly- or commonly-owned subsidiaries. This authority to operate a MESBIC can be with or without actual participation, but the parent SBIC is prohibited from using SBA borrowed funds to capitalize a MESBIC and each licensee must own at least 20 percent of the MESBIC's voting stock, except by prior SBA approval. Once

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[1] SBA Rules and Regulations Part 107, sec. 107.505.

[2] SBIC Industry Review, p. 2.

[3] SBA Rules and Regulations Part 107, sec. 107.3.

properly capitalized, the MESBIC subsidiary can borrow funds from the SBA on its own and it can utilize unused financial eligibility of the parent SBIC.[1]

The most recent amendment to the <u>SBA Rules and Regulations</u> has four important changes that broadens the scope of MESBIC operations:[2]

(1) A MESBIC is now exempt from the diversification of investments requirements, which limits a normal SBIC from concentrating more than 33 1/3 percent of its portfolio in a single major group of business activities as defined by OMB. This allows a MESBIC to gain more expertise in a particular type of business, which is especially important in its managerial assistance program.

(2) MESBIC can now invest as much as 30 percent of its total capital in any one investment. Since MESBICs to this point in time are much smaller in average size than SBICs, this revision allows MESBICs to provide more funds to what is hoped will be larger minority businesses. The objective is to give the MESBIC greated freedom to invest in more than just the more marginal retail type businesses to which the former limit of 20 percent tended to restrict them.

(3) The third key change has been to allow any SBIC/MESBIC to make more loans, within certain limits, for terms of

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[1] <u>Ibid</u>., sec. 107.813.

[2] <u>Ibid</u>.

less than the five year minimum limit formerly required. The new minimum is now thirty months, but the revision applies only to loans to disadvantaged businesses. Although important to both the MESBICs and the SBICs, in terms of being able to roll-over their investments more rapidly, this revision would appear to be directed more toward encouraging SBICs to lend more to the minority business community.

(4) The final important change allows a portfolio investment concern of a MESBIC to use more than the normally allowed 50 percent of the funds received to buy goods and services from a supplier associated with a MESBIC. The maximum amount has been raised to 75 percent.

There are three key factors that differentiate a MESBIC from a SBIC:[1]

(1) MESBICs are allowed to make loans only to business firms that are at least 50 percent owned or controlled by minority interests.

(2) Each MESBIC must be backed by a strong sponsor organization. This sponsor or parent can be a corporation, business, group or organization that can provide, either directly or indirectly, the necessary $150,000 minimum private capitalization for the MESBIC. In addition to capital funds, the sponsor must also commit itself to support a good portion of the MESBIC's

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[1] U.S. Department of Commerce, MESBICs and Minority Enterprise, p. 7.

operating funds as well as managerial assistance to both the MESBIC and the companies in the MESBIC's portfolio.

(3) The MESBIC is prohibited from using more than $12,000, or 8 percent, of its initial capital to support its own operating expenses. It must cover the amount in excess of this maximum by other means, which usually implies the sponsor organization.

The reasons for requiring the strong sponsor concept appears to be twofold. First, the SBA's early experiences with the SBIC industry has made it want to better insure that the marginal SBICs, which caused it so much trouble in the early 1960's, do not reappear as marginal MESBICs. By having a strong managerial staff to assist it, like Arcata National did for Arcata Investment, the MESBIC can maximize its ability to provide the services for which it was designed and not spend the majority of its time trying to keep its own financial head above water. The sponsor can make its whole range of staff services available to its MESBIC, which can give even a newly licensed MESBIC a better degree of managerial maturity.

The second reason for the parent concept is the added functions a MESBIC is supposed to be able to perform for its portfolio firms. As was shown in Chapter II, the black community has not been able to acquire a high degree of managerial expertise and business acumen over the years. Since the emerging black businessmen need managerial as well as financial guidance,

the SBA and OMBE hope that the MESBIC can become a vehicle to deliver both needs to their clients.

In concept, the MESBIC is designed to provide three types of managerial assistance:[1]

(1) Planning. The MESBIC is supposed to help its applicants in developing basic business strategies and plans for the venture in question. This basic guidance is designed to give the applicant a clearer sense of overall direction so that the investment it receives has a better chance of being used to its maximum advantage.

(2) Counseling. Once the investment has been made, the MESBIC tries to maintain a continuing relationship with its portfolio firms, and on a day-to-day basis if necessary. The MESBIC can turn to its sponsor company for assistance in helping to advise the client in answering many "how to" type questions, such as how to submit bids for contracts more effectively. This daily contact also allows the MESBIC to make periodic checks of the business pulse of its clients and possibly anticipate potential problems before they emerge.

(3) Technical Assistance. As problems are discovered, through this hoped for close dialogue between MESBIC and client, the MESBIC can help seek outside assistance that the client may not know exists. There are many organizations and groups, such as the U.S. Chamber of Commerce and the SBA's Senior Core of Retired Executives

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[1] Ibid., pp. 8-9.

who may be able to provide specific assistance at little or no charge to the client.

It can be seen, then, that in concept at least the MESBIC structure can help provide two and possibly all three of what the President's Task Force on Improving the Prospects of Small Business has defined as the three major needs of small businesses: (1) sound managerial counseling; (2) adequate equity capital, the type especially critical to the small businessman; and (3) better trained people.[1] In addition, by establishing a continuing relationship for at least the minimum lending time of thirty months, the MESBIC can help bolster its businesses during much of their initial crucial period. As the Task Force said:

> Statistics show that the first five years of a small business' life are critical for survival. They all show that a very high percentage of business failures are attributable to lack of management competence and experience. Those who finance small business say that financial assistance without effective managerial counseling often leads to ultimate loss. The net result is that small businessmen at times have been hurt by the very financial assistance that was intended to help.[2]

Much has been said in selling the MESBIC program concept of the maximum 15 to 1 potential lending leverage possible. Table 12 shows how this figure is theoretically derived:

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[1]U.S. President's Task Force on Improving the Prospects of Small Business, Improving the Prospects of Small Business (Washington, D.C.: Government Printing Office, 1970), p. 3.

[2]Ibid., p. 6.

TABLE 12

MESBIC LEVERAGE POTENTIAL

Original MESBIC Capital	$ 500,000
SBA Loan to MESBIC.	1,000,000
"Seed Capital" investments in minority ventures	1,500,000
SBA-guaranteed bank loans to minority ventures	6,000,000
Total Capital Flow to minority ventures	$7,500,000

Source: U.S. Department of Commerce, MESBICs and Minority Enterprise, May 1971, p. 22.

In the above example it is assumed first that the MESBIC is able to acquire $500,000 in private equity capital. Then it can borrow $1 million from SBA on a 2 to 1 basis to give it a total capitalization of $1.5 million. Next it is assumed that the MESBIC invests all of its money in minority businesses on an equity basis. The SBA is then prepared to guarantee up to 90 percent of commercial loans to these companies using a maximum debt to equity ratio of 4 to 1. Theoretically, the MESBIC and SBA together have been able to take an initial private investment of $500,000 and leverage it fifteen times over to "create" a total of $7.5 million of new capital to the minority business community.

MESBIC Growth and Performance to Date

When Commerce Secretary Stans announced the MESBIC program in November of 1969, he hoped to have 100 MESBICs licensed

and operating by June 30, 1970. On that date, however, 111 tentative commitments had been made but only sixteen license applications had been received and just twleve MESBICs were licensed and considered operational. By the end of September of 1970, nineteen licenses had been issued. Stans stated that this lag between initial commitment and actual licensing was due to time-consuming but necessary legal work by the MESBIC sponsors.[1] An SBA official confirms this fact but also states that license applications were being closely screened to avoid the problems encountered in the initial licensing of SBICs when quantity was considered more important than quality. The total cost in both bad publicity and problem SBICs had far outweighed any benefits received in the early 1960s by over-licensing.[2]

As of late December of 1970, twenty MESBICs were in operation with an average total capitalization of $300,000.[3] Twenty-nine MESBICs had been licensed by April of 1971, with a total private capitalization of $5.9 million, supplemented by $1.8 million in SBA borrowed funds.[4] These MESBICs had received 1699 loan applications totaling $28.1 million and had disbursed $3 million in funds to 192 different businesses.

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[1]Charles L. Frankel, "The Uphill Road to Black Capitalism," Nation's Business, LVIII (December, 1970), 65.

[2]Kermit L. Culver, private interview at U.S. Small Business Administration, Washington, D.C., January 1972.

[3]"Federal Minority Business Programs Establish 'Solid Beginning' For Future," Commerce Today, I (December 28, 1970), 22.

[4]"Lending To Minority Firms To Build on Early Success," Commerce Today, I (May 3, 1971), 24.

Of these disbursements, 158 had been straight loans, twelve had been purchases of debt securities and only twenty-six had been pure equity investments.[1]

Licensed MESBICs total forty-three in number as of February 1, 1972. They have helped to finance 270 businesses which employ over 2,200 people and have an estimated annual payroll of $11 million with annual sales of over $45 million.[2] These MESBICs have a total capitalization of about $11.3 million and a potential leverage factor which could allow them to provide over $150 million in new financing to minority businesses.[3]

Of the forty-one MESBICs in operation as of December of 1971, a capitalization-size breakdown is shown in Table 13. Eighteen of these MESBICs were capitalized within $10,000 of the minimum of $150,000. The two largest MESBICs, Alyeska Investment Company of Anchorage, Alaska, and Ban Cap Corporation of New York City, are capitalized at $1 million each.

One of the MESBIC concepts is to get the lending institution as close to its potential customers as possible. A MESBIC distribution by location is shown in Table 14. It would appear from this distribution that the MESBICs are attempting to locate in the areas of heavy minority group concentrations. But the

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[1]U.S., Congress, Senate, Select Committee on Small Business, Statement before that Committee by Thomas S. Kleppe, pp. 12-13.

[2]"Nixon's New Program To Strengthen Aid to Minority-Owned Firms," Commerce Today, II (November 1, 1971), 15.

[3]Culver, private interview.

locations of the MESBICs, except for the noticeable paucity of them in the Deep South, do not tell us the extent of the disbursements made.

TABLE 13

MESBIC CAPITALIZATION BREAKDOWN

Total Paid-In Capital and Surplus	Total Number of MESBICs
Not more than $200,000	20
$200,000 to $500,000	18
Over $500,000	3

Source: "Nixon's Administration Responds to Its Black Critics," Black Business Digest, II (December, 1971), 64.

Table 15 gives a breakdown, as of March 31, 1971, of the disbursements by geographical area of the twenty-one reporting of the twenty-eight licensed MESBICs at that time. The figures do confirm that the greatest lending activity has been in the Middle Atlantic, East North Central, South Atlantic and East North Central regions. Even here, though, the figures must be reviewed closely since the preponderance of disbursements going to the South Atlantic region is concentrated in Maryland, with only one disbursement in the District of Columbia. The East North Central region also shows a serious gap with not one disbursement being made in Illinois, most specifically Chicago.

A breakdown of the total outstanding disbursements of these twenty-one reporting MESBICs, by type of industry shows that nearly 75 percent of the total number of disbursements were made to non-manufacturing business concerns, which also received

TABLE 14

DISTRIBUTION OF MESBICs BY GEOGRAPHIC AREA SERVED

Area Served	Number of MESBICs
New York City	9
San Francisco	4
Los Angeles	3
Chicago	3
Newark	2
Seattle	2
Philadelphia	2
Detroit	2
Hartford/New Haven	2
Dallas/El Paso	2
Boston/Springfield	2
Baltimore	1
Bartlesville, Okla.	1
Louisville, Ky.	1
Racine, Wis.	1
Washington, D.C.	1
Alaska	1
Phoenix, Ariz.	1
Sparta (Atlanta), Ga.	1
Winston-Salem, N.C.	1
Indianapolis, Ind.	1

Source: "Nixon's Administration Responds To Its Black Critics," Black Business Digest, II (December, 1971), 64.

TABLE 15

LICENSED MESBIC LOAN AND EQUITY DISBURSEMENTS BY REGION FOR THE YEAR ENDING MARCH 31, 1971

	Loans		Debt Securities		Capital Stock		Total Financing	
	No.	Amount	No.	Amount	No.	Amount	No.	Amount
New England								
Maine	-	$ -	-	$ -	-	$ -	-	$ -
New Hampshire	-	-	-	-	-	-	-	-
Vermont	-	-	-	-	-	-	-	-
Massachusetts	-	-	-	-	-	-	-	-
Rhode Island	-	-	-	-	-	-	-	-
Connecticut	1	2,700	1	10,000	2	60,000	4	72,700
Total	1	$ 2,700	1	$ 10,000	2	$ 60,000	4	$ 72,700
Mid Atlantic								
New York	1	$ 8,000	3	$ 35,000	5	$ 85,007	9	$ 128,007
New Jersey	24	138,534	4	68,000	5	-	28	206,534
Pennsylvania	-	-	-	-	-	-	-	-
Total	25	$ 146,534	7	$ 103,000	5	$ 85,007	37	$ 334,541
East North Central								
Ohio	2	$ 29,000	-	$ -	-	$ -	2	$ 29,000
Indiana	1	14,000	-	-	-	-	1	14,000
Illinois	-	-	-	-	-	-	-	-
Michigan	6	121,288	-	-	1	50,000	7	171,288
Wisconsin	3	34,575	-	-	-	-	3	34,575
Total	12	$ 198,863	-	$ -	1	$ 50,000	13	$ 248,863
Pacific								
Washington	-	$ -	-	$ -	-	$ -	-	$ -
Oregon	-	-	-	-	-	-	-	-
California	66	725,164	1	40,000	8	72,600	75	837,764
Alaska	-	-	-	-	-	-	-	-
Hawaii	-	-	-	-	-	-	-	-
Total	66	$ 725,164	1	$ 40,000	8	$ 72,600	75	$ 837,764
West South Central								
Arkansas	-	$ -	-	$ -	-	$ -	-	$ -
Louisiana	-	-	-	-	-	-	-	-
Oklahoma	2	19,000	-	-	2	11,000	4	30,000
Texas	10	107,000	-	-	1	15,092	11	122,092
Total	12	$ 126,000	-	$ -	3	$ 26,092	15	$ 152,092
South Atlantic								
Delaware	-	$ -	-	$ -	-	$ -	-	$ -
Maryland	4	114,290	1	40,000	-	-	5	154,290
District of Columbia	1	10,000	-	-	-	-	1	10,000
Virginia	1	6,809	-	-	-	-	1	6,809
West Virginia	-	-	-	-	-	-	-	-
North Carolina	2	44,000	-	-	2	37,000	4	81,000
South Carolina	-	-	-	-	-	-	-	-
Georgia	-	-	-	-	-	-	-	-
Florida	1	49,900	-	-	1	200	2	50,000
Total	9	$ 224,899	1	$ 40,000	3	$ 37,200	13	$ 302,099
East South Central	-	-	-	-	-	-	-	-
West North Central	-	-	-	-	-	-	-	-
Mountain	-	-	-	-	-	-	-	-
Puerto Rico	-	-	-	-	-	-	-	-
Virgin Islands	-	-	-	-	-	-	-	-
Guam	-	-	-	-	-	-	-	-
GRAND TOTAL	125	$1,424,160	10	$ 193,000	22	$ 330,8[illegible]	157	$1,[illegible],059

Source: Small Business Administration, SBIC Industry Review.

about 70 percent of the dollar value of these disbursements. The retail trades and service activities combined received just over 53 percent of the total number of disbursements and about 46 percent of the total dollar value. Although it is to be expected that the greatest initial effort of the MESBIC disbursement activity will be in the retail and service areas, since these types of business concerns dominate the ghetto areas, it would appear encouraging that even at an early stage of development, the MESBIC industry is involved in supporting manufacturing type ventures.

The above figures are all derived from Table 16, which further shows a breakdown of these disbursements by loans, debt securities and capital stock. As might be expected, the majority of disbursements are of the loan variety. Only 8 percent of the total number of disbursements to non-manufacturing industries were of the capital stock type, but over 27 percent of the disbursements made to manufacturing industries were of this type.

Table 17 is the first condensed financial statement ever published for the MESBIC industry. By itself it does not tell a very complete story since there are no standards or trends by which to compare it. Yet it does show that the industry sustained a 19.6 percent net loss from operations during its first active year, which decreased its total capital stock by 16.3 percent, or over $855,000.

The industry as a whole appears not even close to being fully-leveraged as far as funds available from SBA are concerned,

TABLE 16

LICENSED MESBIC LOAN AND EQUITY DISBURSEMENTS BY INDUSTRY FOR THE YEAR ENDING MARCH 31, 1971

Industry	Loans		Debt Securities		Capital Stock		Total Financing	
	No.	Amount	No.	Amount	No.	Amount	No.	Amount
Non-manufacturing Industries								
Agriculture, Forestry and Fisheries	2	$ 14,615	-	$	-	$	2	$ 14,615
Contract Construction	7	115,800	2	90,000	3	100,200	12	306,000
Mining	-	-	-	-	-	-	-	-
Transportation, Communications & Utilities	12	81,450	1	10,000	1	15,092	14	106,542
Finance, Insurance and Real Estate	1	36,000	-	-	1	30,000	2	66,000
Services	44	385,155	3	60,000	4	95,400	51	540,555
Wholesale and Retail	43	506,836	1	20,000	2	10,200	46	537,036
Total Non-Manufacturing	109	$1,139,856	7	$ 180,000	11	$ 250,892	127	$1,570,748
Manufacturing Industries								
Durable goods	15	$ 200,700	3	$ 58,000	7	$ 116,000	25	$ 374,700
Non-Durable Goods	16	79,736	1	20,000	6	59,037	23	258,773
Total Manufacturing	31	$ 380,436	4	$ 78,000	13	$ 175,037	48	$ 633,473
Unclassified	-	-	-	-	-	-	-	-
Total All Industries	140	$1,520,292	11	$ 258,000	24	$ 425,929	175	$2,204,221

Source: Small Business Administration, SBIC Industry Review.

TABLE 17

MESBICS CONDENSED FINANCIAL STATEMENTS
AS OF MARCH 31, 1971

Condensed Statement of Financial Condition	21 Reporting of 28 Licensed Companies	
	Amount	Percent
Assets		
Cash and U.S. Government Obligations	$3,421,096	65.3
Loans to Small Businesses (Sec. 305)	$1,520,292	29.0
Equity Securities of SBCs (Sec. 304):		
Debt Securities of SBCs	258,000	4.9
SBC Capital Stocks and Stock Rights for which Separate Costs Have Been Determined	425,929	8.1
Gross Loans and Investments	$2,204,221	42.0
Less: Allowances for Losses	494,329	9.4
Net Loans and Investments	$1,709,892	32.6
Assets Acquired in Liquidation Less Accumulated Depreciation and Allowances for Losses	$ -	-
Less: Mortgages Payable	-	-
Net Assets Acquired in Liquidation	$ -	-
All Other Assets	$ 110,046	2.1
Total Assets	$5,241,034	100.0
Liabilities, Capital, and Surplus		
Borrowings:		
Subordinated Debentures Issued to SBA	$1,800,000	34.4
Funds Borrowed from SBA	-	-
Funds Borrowed from Other than SBA	-	-
All Other Liabilities	127,009	2.4
Total Liabilities	$1,927,009	36.8
Capital Stock, Amounts Paid on Stock Subscribed, and Paid-in Surplus	$4,169,773	79.5
Retained Earnings (Deficit)	(855,748)	(16.3)
Total Capital and Surplus	$3,314,025	63.2
Total Liabilities, Capital, and Surplus	$5,241,034	100.0
Unrealized Appreciation of Investments	$ -	

TABLE 17 - Continued

Condensed Statement of Income and Expense For the Year Ended March 31, 1971	21 Reporting of 28 Licensed Companies	
	Amount	Percent
Income		
Income from Loans and Investments	$ 63,692	37.2
Management Consulting Service Fees	-	-
Net Income (Loss) from Assets Acquired in Liquidation	-	-
All Other Income	107,699	62.8
Total Gross Operating Income	$ 171,391	100.0
Expense		
Interest and Other Financial Expenses	81,528	47.6
Operating Expenses	216,418	126.3
Total Expenses	$ 297,946	173.9
Net Income from Operations Before Provision for Losses and Income Taxes	$ (126,555)	(73.9)
Provision for Losses	$ 686,274	400.4
Provision for Income Taxes	4,133	2.4
Total	690,407	402.8
Net Income (Loss) From Operations	$ (816,962	(476.7)
Realized Gain (Loss) on Investments	$ -	
Less: Provision for Income Taxes	-	
Net Realized Gain (Loss)	$	
Combined Net Income (Loss) from Operations and Realized Gain (Loss)	$ (816,962)	
Net Return on Invested Capital for the Year		(19.6)

Source: Small Business Administration, *SBIC Industry Review*.

having borrowed only $1.8 million based on a paid-in capital of over $4.1 million. Additionally, the industry has not utilized commercial borrowing itself to increase its financial structure.

The fact that over 65 percent of the industry's total assets are uncommitted to investments to minority businesses is disturbing as a whole, but since most of the MESBICs are only about one year old, the reasons for this inability to make more investments cannot be fully explained.

Since any further attempt to draw conclusions from this one picture of the MESBIC industry's financial condition might tend to mislead the reader, no further reference will be made to it except to draw attention to the high provision for loss expense allocation.

One encouraging statement can be made, however, and that is that as of early January, 1972, no MESBIC has been forced to surrender its license for financial reasons.[1] The initial growth of the industry may not be as dramatic as the initial growth of the SBICs, but it appears to be on a bit more of a solid footing.

MESBIC's Potential Effectiveness

Both OMBE and SBA have taken an optimistic but fairly realistic attitude toward describing the current and future effectiveness of the MESBIC program. There is overall confidence in the ability of MESBICs to provide more financing and managerial assistance to minority businessmen, but both Agencies appear realistic in not wanting to oversell the program.

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[1]Culver, private interview.

SBA Administrator Thomas S. Kleppe admits that the MESBIC industry's performance to date has not been substantial, in absolute terms, but at least it has been a beginning in filling a need that no other program was doing. He points out that SBA has been determined to license only sound and well-sponsored MESBICs to ensure that the MESBICs do not become problems in themselves. He speaks highly of the responses he has received from the corporate giants, such as General Motors and Standard Oil, and the degree of corporate commitment they are willing to make toward making the MESBIC program a more successful means of assisting the disadvantaged. Kleppe feels that representatives of national corporations "now have a common forum through the MESBIC vehicle to discuss financial and economic problems of the disadvantaged on a national, as well as a local basis." By becoming directly involved with the disadvantaged on a basis they know best, the business environment, he believes that the corporate giants can give the minority businessmen a significantly greater representative voice speaking for them.[1]

With respect to this representative voice, a listing of the MESBIC sponsors does read somewhat like the listing of Fortune's 500. Some of the better known names include Prudential Insurance, General Motors, Phillips Petroleum, Transamerica, International Telephone and Telegraph (ITT), General Foods, Olin Corporation, Standard Oil, Chase Manhattan Corporation, Sun Oil, Bank of America and Atlantic Pipeline.

[1]U.S., Congress, Senate, Select Committee on Small Business, Statement before that Committee by Thomas S. Kleepe, p. 13.

In addition to the wide variety of sponsors, SBA feels that each MESBIC appears to be structured along lines that best meet the environment in which it exists. For example, Opportunity Capital Corporation (OCC) of San Francisco is sponsored by a consortium of twenty-one corporate investors, including Bank of America and Standard Oil of California. It shares office space and management with Opportunity Through Ownership, another firm that provides special financing for minority businesses. The secretary of OCC is a manager of an investment management firm and other directors represent banking and national industrial firms. OCC then has a strong and experienced managerial background to help it develop over the initial and critical operating years.[1]

Rutgers Minority Investment Company of Newark, New Jersey presents a different type of organizational framework. All capital has been provided by ITT of New York, but the graduate business school of Rutgers University provides the office space and management assistance to the MESBIC. This arrangement provides a unique opportunity for potential future corporate leaders to actively participate as business consultants and to gain a better understanding of minority business problems.[2]

A final example of the flexibility possible in organizing a MESBIC is the case of the soon to be operational Minority Equity Capital Company (MECCO). The initial capitalization of $1.2 million for MECCO comes from the Ford Foundation and the

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[1] Small Business Investment Company Digest, pp. 23-24.

[2] Ibid., pp. 37-38.

Metropolitan Life Insurance Company. Although based in New York City, this MESBIC will invest in minority businesses in New York, Newark, Washington, D.C., Los Angeles, New Orleans, Dallas and St. Louis. The reason MECCO will be able to reach a broad geographic area is that it will be an affiliate of the Interracial Council for Business Opportunity (ICBO), a highly successful minority enterprise business consulting organization also funded by the Ford Foundation.[1] This coupling of a proven minority business management assistance organization in seven cities with a centrally available equity funding organization would appear to have a tremendous total assistance potential.

The Commerce Department's OMBE has assessed the MESBIC in terms similar to that used by SBA. It cautions potential sponsors not to begin a MESBIC without adequate pre-planning and a gradual start-up phase. OMBE further advises that a MESBIC should be prepared for many potential failures in its investments and that it must be willing to stand by its clients for relatively long periods of time. A MESBIC is further advised to keep a low profile in the community and be sensitive to the desires and goals of the businesses and community it serves.[2]

It would appear by the tone of these assessments that both Agencies would rather be a bit deliberate in developing the MESBIC industry in order to avoid the setback experienced in the early years of the SBIC industry. This confidence factor

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[1] "Ford Foundation Invests Millions to Promote Minority Enterprise," Commerce Today, I (December 28, 1970), 25-26.

[2] U.S. Department of Commerce, MESBICs and Minority Enterprise, pp. 13-15.

is a vital one since the ultimate success of the MESBIC program hinges to a great degree on how well the minority communities accept and use this Federally-backed program.

The MESBIC program is not without its critics, though, and two of them are Richard S. Rosenbloom and John K. Shank of the Harvard Business School. Both writers collaberated in a Harvard Business Review article late in 1970 in which they advocated total abandonment of the program since they consider it wholly ineffective in both concept and operation.

Rosenbloom and Shank concede that minority economic development can proceed faster than it has in the past only with a great influx of capital, but that the MESBIC program is not the proper vehicle.

They first analyze the program from a straight business approach, and advise potential sponsors to look at a MESBIC using the same "managerial scrutiny" as they apply to their own businesses. In other words, if a corporation wishes to make a social commitment to fostering minority business development, it should measure the potential success of a MESBIC venture under a common capital investment criteria with other possible vehicles for achieving the same goal. Businessmen should not allow themselves to be oversold by the Government on the merits of MESBIC as a means of meeting the goal when there may be better vehicles available.[1]

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[1]Richard S. Rosenbloom and John K. Shank, "Let's Write Off MESBICs," Harvard Business Review, XLVIII (September-October, 1970), 90-91.

According to Rosenbloom,[1] two crucial assumptions underlie the MESBIC program, and both are probably incorrect. The first assumption is that "excess capital" from the white community can be induced into the program. This assumption is considered wrong since no substantial amount of "white" money can be drawn into the ghettos when the risks are so high and the potential rewards so little. The SBA loan guarantee program, to him, has not stimulated a much greater amount of minority business lendings. The second assumption is that the minority businessmen will be able to repay their loans in periods of fifteen or twenty years. Rosenbloom feels this assumption fails to recognize that any new businessman, regardless of color, needs really permanent equity capital and that an "all-debt financing" medium, regardless of the length of maturity, must eventually be repaid, and with interest. He does not feel that many businessmen can repay their entire equity base in this period of time and still have enough of their own capital, accumulated primarily by the earnings of the business, to remain at the same financial size to which they have hopefully grown.[2]

Rosenbloom feels the MESBIC program does not provide any new methods for corporations desirous of helping minority businesses since it is based on the same model as the SBIC program. He challenges the potential 15 to 1 financial leverage the SBA and OMBE claim for the program on the grounds that there

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[1]For purposes of simplicity, further references to both Rosenbloom and Shank will be made by referring only to Rosenbloom.

[2]*Ibid.*, p. 92.

is no assurance that commercial lending institutions will be this liberal on a 4 to 1 equity to debt ratio. He is further critical of the minimum capitalization of $150,000 required by SBA on three grounds. First, he cites SBA figures that show that it was the small SBICs that caused them so much trouble in the mid-1960's. Second, he believes that the smallness of the MESBICs will only foster a greater proliferation of marginal retail businesses, since the maximum investment restriction does not give a MESBIC an opportunity to help develop new businesses of a large enough scale to really benefit the ghetto communities. The third criticism concerns informal SBA guidelines which require that a MESBIC must have at least two well-qualified full-time managers on its staff. He feels that this excessive overhead burden even with sponsor support will make a serious cash drain on the MESBICs treasury.[1]

Leaving the faulty operating characteristics of a MESBIC from a purely business standpoint, Rosenbloom next looks more closely at the basic purposes that a program such as MESBIC should have if it is truly intended to bolster the economic potential of the communities served by the minority businesses. He sees that the development of local businesses should strengthen "three interlocking 'economies' in the community," which includes:

> 1. The income economy -- Development improves the community standard of living by increasing earning capacity and hence purchasing power; or by making goods and services available at lower prices; or both.

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[1]*Ibid.*, p. 94.

2. The political economy -- Development enhances the political power of the community by increasing its control over important economic resources.

3. The psychological economy -- Development raises the self-esteem of both the individual and the community through increasing the community's control over itself.[1]

Rosenbloom feels that control is a central issue here and that it is this control that a minority business has to strengthen the three economies of its community that is of real importance. Although the income economy is important, he feels that the major potential contribution a stronger minority business sector can make is in strengthening the political and psychological economies of its community. To accomplish this objective will require the development of larger, more efficient businesses that can truly compete in the economic mainstream. The MESBIC program, by its emphasis on the marginal businesses, cannot do this. A final drawback is that if the vehicle to supposedly help develop these new business enterprises is controlled by the same white outside interests that already dominates the black community, then the political and psychological objectives cannot be met because the community still has not received its independence.[2]

In conclusion, Rosenbloom believes that while there are some technical adjustments which can be made to help make the MESBIC a more viable instrument, like raising the minimum capitalization from $150,000 to $250,000, it still cannot resolve this basic dilemma of being white-owned. As long as

[1] Ibid., p. 95.

[2] Ibid., pp. 94-95.

control is not in the hands of the black community, the ultimate objectives cannot be met.[1]

Probably the best known and most quoted critic of all Federal disadvantaged welfare and assistance programs is Theodore L. Cross, lawyer and editor-in-chief and publisher of The Bankers Magazine. His book Black Capitalism: Strategy for Business in the Ghetto proposed a broad scope plan of community development which he is now beginning to put into action on an experimental basis in the Office of Economic Opportunity.

Cross starts at the beginning by trying to define the objectives of our government-industry programs to stimulate economic development in the ghetto. Although not openly critical of the workings of the MESBIC program, per se, he does challenge the entire concept of any program to create a greater supply of black businesses. He feels that in so doing, we are creating a supply when there is no demand. Cross firmly believes that we must follow the teaching of Lord Keynes and worry first about creating reasons for having truly viable larger-scale minority businesses, of a size that have a real impact on the minority communities. This means that we must first create a demand for goods and services that no one is now satisfying. If this demand is strong enough and only the minority business community can satisfy this demand, then new black businessmen will clamor to meet this demand. They will be adequately financed, too, since the commercial lending institutions will be more than

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[1] Ibid., pp. 96-97.

willing to take a lending risk because this risk will be far outweighed by the potential profit gains.[1]

If we are truly serious about minority business development, then Cross feels we should begin by working with the only side of the basic supply-demand equation that can really be controlled by the government. As he states:

> We will then set aside either through tax incentives, direct rewards, legal sanctions, or through a redirection of government purchasing -- a segment of national economic scarcities than can be satisfied only by the mercantile acts and employment of disadvantaged people of their neighborhood corporations.[2]

Cross feels that the easiest and most controllable place to start is in the whole area of Federal procurement. By establishing firm and sizeable set-aside rules for direct Federal spending and using clauses in prime procurement contracts which require a greater degree of subcontracting through disadvantaged businesses, we can create this demand for goods that will in turn create a demand for businesses. If this situation can be successfully brought about, most of the current business stimulation programs, like MESBIC, may no longer be required.[3]

The total Opportunity Funding Corporation concept that Cross advocates brings in many aspects of ghetto community development that extend far beyond the scope of this paper. However, his concept of rigging the forces of the marketplace

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[1]Theodore L. Cross, "A White Paper on Black Capitalism," Black Business Digest, II (November, 1971), 15-16.

[2]Ibid., p. 16.

[3]Ibid., pp. 16-17.

in favor of disadvantaged businesses could be a highly dynamic mechanism to stimulate the development of a truly needed supply of disadvantaged businessmen.

CHAPTER VII

CONCLUSION

The Primary Question

The primary question this study has sought to answer is whether the MESBIC program can become an effective Federally-sponsored vehicle for providing venture capital to black businesses. My conclusion is that it can, but only if its objectives are more carefully defined and segmented and if its structure and method of implementation are changed in line with its revised objectives. The concept is good, the need is present and the potential for success is favorable. But as the MESBIC program is currently attempting to function, it stands little chance of being an effective vehicle for helping black business to achieve the degree of viability sought, either in ghetto economic development or in entering the economic mainstream. Before describing some changes which may be necessary to make the MESBIC program more effective, a brief review of the findings of this study will be made.

Summary of Findings

First, it has been shown that black-owned businesses are not even closely operating in the American economic mainstream. Nor are they making more than a very minor impact on

the economic development of black communities. Second, the black communities themselves are caught in an economic deprivation trap from which they cannot escape on their own. Racial discrimination plus the lack of a business heritage have kept blacks from acquiring the entrepreneurial and managerial expertise and an accumulated wealth base by which to build a strong business community. Business and economic opportunities are becoming more readily available to them, especially in the inner cities from which whites are fleeing at an increasing rate. Yet the majority of these opportunities are of marginal profitability, since they are located in high unemployment areas where high incidents of crime and social unrest make the probability of success extremely unfavorable. Third, although the banking communities, both black and white, are making small but sincere attempts toward becoming more available to black businessmen, the element of risk is still so high that even the most liberal banker is able to assist to only a limited degree. The conclusion, then, is that if real progress is to be made in fostering greater black business development, which must be considered an unquestionable public goal on both moral and economic grounds, it cannot be made without the aid of the Federal government. This is true especially in the area of providing necessary venture capital.

The SBA loan programs have been effective in providing more direct money to black businessmen and in supporting commercial loans made to them. But loan programs alone can only be used to leverage privately invested equity capital, the key financial ingredient most potential black businessmen lack. The SBIC program, designed to serve the same equity needs of small

businessmen in general, has had a turbulent history. Even fourteen years after its founding, this industry must still be considered only marginally effective, and the element of racial discrimination has not been a factor. But from it came the basic framework and legislative background by which the MESBIC program was founded.

The MESBIC program has been modified somewhat to overcome the inherent shortcomings of the SBIC program, but after a little over two years in operation it is hardly the panacea of the minority businessman's equity capital needs. Probably the most basic problem of the program is that there is really no clear-cut definition of its objectives. If we want to get more black businessmen in the economic mainstream, then its minimum capitalization requirement of only $150,000 will not allow this to happen. By this, a business may be interpreted as being in the economic mainstream only when it has a marketing base that at least transcends the inner cities and serves customers of more than one color. Conversely, if we want to make true economic development in the ghetto areas, the program is weak in that it operates in a vacuum with respect to being part of any overall ghetto development program.

Another weakness of the present MESBIC program, which is somewhat akin to the criticism of its operating in a vacuum, is that it tends to mix up the order of the four ingredients necessary to create a viable business. The concentration seems to be on getting money first, then in finding the right man, and hope that he has some entrepreneurial expertise, and finally in

looking for the profitable business opportunity. This follows Theodore Cross' idea that we are concentrating on finding a supply of businessmen first and then on looking for a product demand in which to employ them, instead of concentrating on the demand function first. If this premise is not correct, the question has to be raised as to why the MESBIC industry, and even the SBIC industry, has such a large portion of its assets as yet uninvested. Nor have the SBICs or MESBICs fully used their SBA borrowing potential. Granted that many MESBICs are still getting organized, it still seems strange that if there are that many good investments around, then MESBICs should be a bit more heavily invested, and more of their investments should be in equity ventures rather than in debt lendings. The point being that it appears that the MESBICs are not yet attuned to the needs of the communities they serve, because I do not concur with Cross' belief that there are little current demands for black businesses. The blacks living in the ghettos are spending their money somewhere, and they could be spending at least some of it in black-owned businesses.

The program also fails to allow for some solution to the dilemma a really active MESBIC can find itself in if it is actually fully invested. Since the minimum portfolio turn-over is five years, assuming the investments are of an equity nature which is the purpose of the program, the MESBIC is stymied from further activity for this period of time unless it can raise more capital.

Finally, the OMBE/SBA "coordinated effort" has been somewhat less than that. By the President's directive, OMBE is the minority business development coordinating arm of the Federal government. However, the money for the program, the legislative authority for licensing and regulating MESBICs and the responsibility for MESBIC performance belongs solely to SBA. OMBE announced the program and OMBE set the goal of 100 MESBICs by June 30, 1970. Yet it was SBA's responsibility to meet this unrealistic goal. A Robert Morris Associates study on the financing of minority business quotes a Chamber of Commerce report which states that there is a legacy of "bitter inter-agency squabbles, the absence of clear lines of authority and direction, and a continued lack of strong Presidential visibility" which has lessened the impact of the Administration's efforts in behalf of minority enterprises.[1]

It would seem then that OMBE may be more of a hinderance than a help to the cause of black business development. By the same token, though, without OMBE's push, SBA may never have developed the program on its own.

Assessing the MESBIC Potential

The President's Advisory Council on Minority Business Enterprise has found that although all of the factors required to stimulate minority economic development are not known, it is known that the development of a viable economic base is essential. It further states:

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[1]"Financing Minority Businesses," p. 33.

> The time is ripe. Throughout the nation's minority communities, there is a growing demand for sufficient economic independence to participate effectively in the system. Too often, a lack of access to the power structure breeds an atmosphere of frustration and anger . . . the disadvantaged, particularly the poor, cannot help but be aware of the discrepancy between their economic condition and that of the larger society.[1]

Blacks appear to be willing to live in a semi-peaceful coexistence with the majority community, at least temporarily, to see whether it is really sincere in its promises of helping blacks acquire greater economic independence. A recent shooting of a black burglary suspect by the police in Hunter's Point, a black ghetto of San Francisco, points out his sense of restraint. Whereas a similar incident in 1966 created a riot that required 2,000 National Guardsmen to quell, this time Hunter's Point black community action leaders kept the lid on the ghetto and instead sought legal remedies to this potentially unjustified homicide. This change of attitude was due mainly to the fact that the Hunter's Point residents now have an economic stake in their community and do not wish to see it destroyed. By a slow, systematic process of elimination, blacks are buying out white-owned businesses and are developing a viable economic base on their own.[2]

In addition, more white businessmen are becoming increasingly attuned to the needs of black businessmen and are willing to participate in black business development. They are

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[1]Minority Enterprise and Expanded Ownership: Blueprint for the 70's, p. 5.

[2]David DuPree, "Joining the System," The Wall Street Journal, Jan. 4, 1972, p. 1.

willing to provide money, managerial talent and moral support to their black counterparts, but need a successful vehicle by which to channel their efforts.[1]

Blacks also appear to have the talent, the desire and the determination to become successful businessmen. Ed Murphy, a District of Columbia black who grew up in the heart of the city's ghetto, is about to build a $7.5 million black-owned hotel which may be but the start of a whole series of large-scale business ventures for him. Owner of a supper club and a super market, Murphy fought long and hard to get financial backing for his new venture. He finally received his money, after three and a half years of hard work, from the Economic Development Agency, under a disaster-loan grant. Even here, though, most of the money will not go directly to him but to a nonprofit organization that will lease the hotel to him. As Murphy has said:

> When a black is applying, and the people reviewing the loan run into a snag, instead of looking for alternatives, they want to throw it out. . . . If I had it to do over again, I'd rather pay more interest for a bank loan. You can't imagine how nerve-wracking it's been for a man of action like me.[2]

Carolyn Walker of the District of Columbia's Interracial Council of Business Opportunity Office[3] and Michael Wallach of

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[1]Michael Brower and Doyle Little, "White Help for Black Business," Harvard Business Review, XLVIII (May-June, 1970), 4-6.

[2]Aileen Jacobson, "The Gamble of A Black Businessman," The Washington Post, Potomac Magazine, Jan. 16, 1972, p. 14.

[3]Carolyn Walker, private interview at Interracial Council For Business Opportunity, Washington, D.C., January, 1972.

the Mayor's Economic Development Committee[1] both echo Murphy's words and contend that there are plenty of potentially successful black businessmen available if only they would be given a fair chance.

There are also plenty of readily available business opportunities. The District of Columbia Metropolitan Transit System (Metro) development fiasco is a good case in point. Metro has been able to award only about $1.5 million of the first $300 million in contracts to black-owned firms. Metro officials claim that the reason for this is that the black bidding firms have neither the "financial or technical capabilities to handle most of the more lucrative contracts."[2]

In the industrial world itself there appears to be a growing demand for new suppliers. As large-scale manufacturing concerns continue to specialize more on the production of finished end goods and less on the production of fabricated parts, the percentage of component parts being purchased externally is constantly increasing in comparison to the number of parts being produced internally.[3] As modern purchasing, or materials management, functions increase in importance, buyers are constantly seeking new sources of supply. In many cases, a manufacturer is faced with the prospect of creating a new supplier to meet his

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[1]Michael Wallach, private interview at Mayor's Economic Development Committee, Washington, D.C., January, 1972.

[2]Kirk Scharfenberg, "Metro Impact Already Large," The Washington Post, Jan. 9, 1972, sec. N, p. 1.

[3]Lamar Lee, Jr., and Donald W. Dobler, Purchasing and Materials Management (New York: McGraw-Hill Book Company, 1971), p. 8.

needs. In such instances, these companies are willing to provide a new supplier with financial, technical and managerial assistance as well as a ready market for his products.[1] So contrary to popular belief, I believe that the trend toward industrial bigness can create a ready demand for more minority businesses concentrating in the manufacturing industries.

In view of these facts, I believe that the MESBIC can become an effective vehicle for providing venture capital, as well as other vital ingredients, to minority businessmen. First, it is privately capitalized and managed, which means that the Federal government can withdraw its financial support someday without disturbing the managerial operations of the MESBIC. Second, it provides the best vehicle in which a white businessman can channel his efforts, both financial and managerial. He can do that which he knows how to do best -- advise others in how to organize and manage a business more effectively. Third, MESBIC is a local delivery vehicle that can adapt and blend in to the total community effort. The SBA can act as a regulatory body over the MESBICs in the same manner that the Securities and Exchange Commission regulates normal investment brokers, without direct government management in local community affairs. The Federal government can thus maintain a very low profile in the black communities and let the communities and the private white sector learn to work together toward a common black determined goal of economic development. Finally, MESBICs can help to

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[1] Ibid., p. 85.

create some black businesses that are able to enter the economic mainstream and some that can make a significant contribution to the economic development of the ghetto communities.

Recommendations For Change

The first thing needed to make the MESBIC a more viable instrument of public policy is a better sence of national direction, purpose and degree of commitment to the needs of black business and black economic development. Simply stated, this means that we must determine how badly we want to achieve these goals, how much of our national resources we are willing to commit to these purposes and what kind of payoff are we demanding from our Federal investments.

The President's Advisory Council on Minority Business Enterprise (PACMBE) has recommended no less than a high national priority and believes that the creation of a super-bureau to house the total efforts of such agencies as SBA, OMBE, EDA and parts of OEO and the Department of Agriculture is a must. It also recommended that this super-bureau, which it calls the Agency for Expanded Ownership, develop a network of 100 local delivery centers to act as the focal point of all Federal, local government, local community and private industry efforts.[1] This would allow broad goals and policies to be left on the Federal level, but allow the local consortium to modify and implement these goals and policies in light of local needs and conditions.

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[1] *Minority Enterprise and Expanded Ownership: Blueprint for the 70's*, pp. 1-10.

The President responded to this recommendation by strengthening the role of OMBE and by establishing these 100 local delivery centers under OMBE's direction.[1] Whether this less dynamic approach is better or worse than the problems of creating a new super-bureau must be left to students of political science to determine. Nevertheless, there now will be a better local coordinative effort, which in turn may filter up to the parent agencies. This will provide a better framework in which a MESBIC can operate more effectively in its ghetto economic development role.

This leads to the next issue which concerns the role of the MESBIC itself in the local consortium. The government must redetermine the objectives of the MESBIC program and structure it according to the objectives. I contend that we need two varieties of MESBICs, those focusing on ghetto economic development and those focusing on the national markets of the economic mainstream.

The ghetto oriented MESBIC can be developed on a lower capital basis, since it will be supporting more retail and service type of needs, and be more diversified in its investment portfolio. Those sponsoring these MESBICs should be industries that have this type of expertise, such as grocery, clothing, hardware, restaurant, banking and entertainment type of industries. They are geared for consumer marketing efforts and can be more responsible to the needs of the local develop consortium. I am not advocating marginal businesses but merely the smaller

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[1]U.S. President, Proclamation, "Promoting Minority Enterprise," Federal Register, XCII, No. 169, Oct. 13, 1971, 9478-9479.

but potentially viable retail and service businesses that are necessary in any community.

The economic mainstream type of MESBIC must be capitalized on a much higher level, since it will be sponsoring manufacturing, construction and wholesale type of enterprises. These MESBICs should be allowed to concentrate their total portfolios in one segment of an industry, such as electronics, in order to capitalize on the expertise of the sponsoring firms. They should also be allowed to develop nearly subsidiary type businesses to ensure a necessary market for the products of the new concerns. Of course this aspect will have to be closely monitored by SBA and an eventual tie-cutting mechanism will be required. But if we really want to allow these new industries to prosper, we must be willing to allow some early monopolization. I see no difference between this and the restrictive quota and tariff mechanisms we use to protect our industrial giants, such as the steel and textile industries, from foreign competition.

PACMBE also recommended that we allow non-profit MESBICs to be formed; that SBA or some other agency such as the Opportunity Funding Corporation be allowed to rediscount and repackage MESBICs portfolios to give them a new capital injection; that SBA be allowed to match MESBICs on a 6 to 1, vice the current 2 or 3 to 1, basis if total capitalization is in excess of $1 million; that MESBICs be encouraged to have programs managed by the local delivery offices; and that better incentives

be offered to industries in order to encourage them to sponsor a MESBIC.[1]

I do not agree that we should allow for the formation of non-profit MESBICs since it is likely to turn-off some of the white businessmen who will want to keep this in the realm of a business venture. Nor should MESBICs be managed by the local delivery offices.

The MESBIC should be kept in proper perspective. It should be the exclusive domain of the majority business community to sponsor and manage as a capital-providing and managerial-assisting institution just like a normal investment house. The MESBIC will be coordinated under the local delivery center coordinative effort, but as a financial arm. The local delivery center can better utilize its efforts in developing a broad business development plan and in seeking out potentially profitable business ventures and businessmen. Once these are found, the MESBIC job begins and the MESBIC/black businessmen relationship should be long and continuing. This also presents one potential weakness in the PACMBE rediscounting mechanism. While vitally needed to allow the MESBIC to turn-over its portfolio more quickly, the MESBIC must be felt to be responsible for the investment, even if it no longer holds the paperwork to ensure that it continues the close rapport with its portfolio businesses.

One final, but vital, consideration that must be properly understood is that MESBICs will not become profitable in the

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[1] Minority Enterprise and Expanded Ownership: Blueprint for the 70's. pp. 47-49.

short-run or possibly not even in the intermediate-run. OMBE and SBA insistance that white businessmen should sponsor a MESBIC on the grounds that it can realize a substantial return on its investment by the capital gains its portfolio investments will bring is unrealistic. MESBICs should still remain profit-oriented but if good sponsors are to be attracted, the program must allow for more tax write-offs and other direct sponsor incentives to make it worthwhile to invest more substantially in the MESBIC and to have the sponsor assign really good managerial talent, and black talent wherever possible, to directing the MESBIC.

As a final note, the roles of OMBE and SBA must be clearly defined in the area of who is responsible for what with respect to MESBICs. OMBE, with its easier access to the corporate giants by being part of the Commerce Department, might better concentrate on marketing the MESBIC product to big business. Once the sponsors are found, OMBE should let SBA take over from there in the technical organizing, licensing, and regulating of the MESBIC. If the roles are clearly defined, conflict can be kept to a minimum.

Conclusion

In summary, then, there is a vital place for the MESBIC concept in the redevelopment of the ghettos and in helping minority enterprises enter the economic mainstream as long as the goals, objectives, structure and controls of the program are

properly designed. But if MESBICs are allowed to proceed on their current non-directed course as a modified SBIC, the 100th MESBIC may never be licensed.

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